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# TAX REFORM PROPOSALS—XXVI

# HEARING

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

OCTOBER 9, 1985

**(Minimum Tax Issue)**

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# TAX REFORM PROPOSALS—XXVI

WEDNESDAY, OCTOBER 9, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, DC.*

The committee met, pursuant to notice, at 9:49 a.m. in room SD-216, Dirksen Senate Office Building, Hon. Robert Packwood (chairman) presiding.

Present: Senators Packwood, Grassley, Long, Bentsen, Matsunaga, Moynihan, and Pryor.

[The press release announcing the hearing follows:]

[Press Release No. 85-076, Monday, September 23, 1985]

MINIMUM TAX, ALTERNATIVE TAX PROPOSALS DUE FINANCE PANEL HEARINGS

Minimum tax and alternative tax reform proposals will be examined by the Senate Committee on Finance at hearings scheduled October 9 and October 10, Chairman Bob Packwood (R-Oregon) announced today.

The hearings are components of the continuing series of hearings in the Committee on Finance on specific aspects of President Reagan's tax reform proposals, Senator Packwood said.

The minimum tax issue will be the topic of a hearing on Wednesday, October 9, 1985, while alternative tax reform plans will be reviewed at the committee's Thrusday, October 10, 1985, hearing.

Both hearings are scheduled to begin at 9:30 a.m., in room SD-215 of the Dirksen Senate Office Building in Washington.

Senator Packwood will preside at both hearings.

Guests invited by the committee on Finance will testify at the two hearings.

Senator MOYNIHAN. Good morning, ladies and gentlemen. As you see, there are meetings going on all over the Capitol today, and our chairman, who is normally here promptly at 9:30 is not here yet and has asked that I chair the hearing until he or some other member of the majority arrives. And so I will do.

Our purpose today is to acquire a record with respect to the whole subject of the minimum tax. And we have some very familiar faces here with us, Mr. Shapiro and Mr. Sunley, most particularly, who we hardly recognize when they have had a night's sleep. But it's nice to know that there is life on the outside and that it has recuperative powers.

Our intention is to begin with a panel that will address the subject of a minimum tax from the perspective of tax theory and tax policy, as opposed to the specifics of which tax preferences should be included in such a tax. I might say before we begin that I introduced a minimum tax in the last Congress. It was a serious one, that initially passed the Finance Committee. It then encountered fierce opposition from real estate interests in the country and the Finance Committee met late one evening, in one of our rare closed sessions, took a vote and the bill lost 10 to 9, whereupon then-chairman Dole said, very well, we will increase the depreciation period for real estate from 15 years to 20—which in conference with the House, was dropped to 18 years.

We are back again this year. Yesterday, the Senate adopted almost unanimously a resolution saying we should have a minimum tax on corporations. Senator Chafee and I have introduced legislation this session, S. 956, similar to the one we introduced in the last Congress. But we still need to know more about the subject.

And I hereby, with the powers invested in me, impanel four of the more distinguished and learned students of this subject, Mr. Bob Shapiro, director of tax policy at Price Waterhouse; Prof. Michael Graetz, of Yale; Professor Gutman of the University of Pennsylvania Law School; and Emil Sunley, director of tax analysis for Deloitte, Haskins and Sells.

Would you all come up, please. And I must apologize for the absence of other members, but I want you to know that what you have to say is going to be listened to with great attention by me and read with attention by other members of the committee and the staff.

Let's follow our witness list: I would therefore ask Mr. Shapiro to lead off.

Mr. Shapiro, welcome back to the Finance Committee.

## STATEMENT OF MR. BOB SHAPIRO, NATIONAL DIRECTOR OF TAX POLICY, PRICE WATERHOUSE, WASHINGTON, DC

Mr. Shapiro. Thank you, Senator Moynihan. It certainly is a pleasure to be back. It seems like this is a chair that I occupied for many years under different circumstances. And seeing what you are going through now, I guess that's one of the reasons why I left. [Laughter.]

Mr. Shapiro. For the record, I'm Bob Shapiro, the national director of tax policy for Price Waterhouse. And I appreciate the opportunity to be invited as a witness on the minimum tax for your fundamental tax reform hearings in the Senate Finance Committee.

The question is often asked is a minimum tax necessary. And the the answer is clear that it would not be if you had a broad-based income tax. However, under our tax system, we use our tax system as a means to encourage economic policies, social policies, energy policy, trade policy, and for many other purposes. In that context, we have a minimum tax to add credibility to the system. The main purpose of the minimum tax is to provide fairness for the system. We want to ensure that high income taxpayers and profitable corporations do, in fact, pay their fair share of taxes.

The concern that exists is that many of these taxpayers may use an excess of any one preference or stack a number of preferences to the extent that they may not pay what would be preceived as their fair share by reducing their tax burden to an unacceptably low rate or possibly pay no tax at all.

Even if you had fundamental structured tax reform in dealing with a lot of these provisions, you still may need a minimum tax to provide the underlying fairness and credibility to the system overall. For example, in 1969, when Congress enacted the minimum tax, they reviewed many of the other preferences. In many cases, they eliminated certain preferences that they perceived were no longer necessary. In other cases, they cut back and modified some of those preferences.

At any rate, the minimum tax was looked at as a backstop to those preferences as a means to provide an insurance that all taxpayers would pay what was perceived to be a fair share at that particular time.

Looking at the structure of the minimum tax, the big debate existed in 1969 and thereafter as to whether we should have an add-on minimum tax, which essentially is an excise tax; or an alternative minimum tax whereby you pay the greater of the minimum tax or the regular tax, after computing both.

In 1969, the decision was for an add-on minimum tax, which I supported being a member of the staff at that time because it was a low rate, a 10-percent rate, and the concern was to make sure taxpayers paid a tax on the preference income. That was a major concern at that particular time. And with a lower rate, it would seem like it would ensure that those preferences that did encourage some tax—it was a means of providing it.

Since that time, the exemption levels have been reduced, the rate has been raised, many more preferences have been added, and I feel that it is appropriate to shift for corporations now, as is presently the case for individuals, to go to an alternative minimum tax for both individuals and corporations.

The structure of the minimum tax is to have focus on the exemption, the rate and the preference items. Those are the three elements of a minimum tax.

The exemption is a means to target the minimum tax to make sure that you have the minimum tax applied to those taxpayers you feel should be subjected to it. For example, if you have an exemption level too low, you may impose a minimum tax calculation on taxpayers at income levels that you don't feel should be subject to a minimum tax. And, therefore, a minimum tax can be targeted to make sure the taxpayers below a certain income level do not have to worry about the computations and the complexities that go with having a whole new tax structure dealing with certain preferences. And that is one of the principal purposes to where it is to be set.

It was set at a higher level in 1969 and in varying degrees over later bills, has been reduced. The rate is used as a means to encourage what is the appropriate rate that a taxpayer should pay on that alternative minimum tax. The point is it's used today in the focus as to how much revenue should be paid. And, therefore, it has two purposes—the revenue and the appropriate level.

For example, some may say that a 10-percent rate is too low, and perhaps a 25-percent rate may be too high, depending on what the other rate is on the regular tax. Somewhere between 15 and 20, in that range, may be an acceptable rate in determining as to what should be the appropriate levels. You have to keep in mind in that respect as to the level of the rate takes away the benefits or the incentives that have been provided for the certain activities. And that should be coordinated with the preference that has been added and the rate in that respect.

The base itself, meaning what preferences should be included, is very important to determine as to what items should be taken into account. Two basic items: Exemptions and deferral items. Exemptions meaning areas that are not subject to tax can clearly be put into the minimum tax base because that would be the only time they would be subject to tax. Deferral items, the subject attacks twice. Once to the case of the minimum tax and then a second time when the deferral comes back in later years is subject to the regular tax. And, therefore, that consequence should be taken into account at the time when you consider putting deferral items into the minimum tax, especially at a higher rate. And that should take into account other aspects of the minimum tax, such as carryovers, what you do with investment tax credits, net operating losses and so forth, which really are very important as you make the minimum tax a little bit stiffer.

The final two comments deal with revenue considerations and complexity. I personally do not believe that a minimum tax be used as a means to be a big revenue raiser. It should be used as a fairness issue, the credibility to the system, to make sure all taxpayers are paying their fair share.

The complexity issue is a very major one because to the extent you apply it to too many taxpayers, meaning they have a regular tax system and the minimum tax system, and you are further complicating the system, which means that great care should be taken to review as to how the whole system is put together with that taken into account.

At this point, I will conclude.

[The prepared written statement of Mr. Shapiro follows:]

# TESTIMONY
OF
BERNARD M. (BOB) SHAPIRO
NATIONAL DIRECTOR FOR TAX POLICY
PRICE WATERHOUSE
BEFORE
THE COMMITTEE ON FINANCE
UNITED STATES SENATE

OCTOBER 9, 1985

Price Waterhouse

Mr. Chairman and members of the Senate Committee on Finance, thank you for inviting me to testify today on the minimum tax as part of your hearings for fundamental tax reform. My name is Bob Shapiro, and I am the National Director for Tax Policy for Price Waterhouse. It is indeed a real pleasure for me to be back in the chair that I occupied for so many years as a member of the staff.

## Purpose of the Minimum Tax

The question is often asked whether a minimum tax is good tax policy and whether it is necessary as part of our tax system. It is not easy to give a definitive answer. A minimum tax clearly would not be necessary if our tax system consisted of a broad base with low rates. But we do not have such a system. Even with substantive tax reform, we will continue to provide special rules for the taxation of certain sources of income and for the treatment of certain expenses and deductions.

For many reasons, there is a general consensus, which I support, that a minimum tax is necessary so that taxpayers will have faith in the fundamental fairness of the tax system. It is intended to assure that high-income taxpayers pay their fair share of taxes -- that is, to prevent taxpayers from stacking up several of the special incentives and thus reducing their tax burden to an unacceptably low level or possibly avoiding tax liability altogether.

Even in the context of thorough tax reform, many of these special rules and exceptions to full, current taxation of income will continue to be accepted as useful or necessary. Nevertheless, Congress must continue to prevent any particular taxpayer -- individual or business -- from combining these special provisions or using any of them to such an extent that their tax liabilities are reduced below some minimum level. That minimum level, in the case of individuals, is perhaps the rate that would be paid by a moderate income wage earner, who has little preference income and who does not itemize.

This is not a question of which preferences one may like or dislike -- all of these special rules have been enacted in the tax system for a specific reason. A minimum tax is not an attack on tax preferences, but rather is used as a means to prevent any taxpayer from not paying a fair share of tax.

Thus, it is necessary that a minimum tax be included in the Code to maintain the credibility of the system, not because the regular tax is necessarily faulty, but because the regular tax cannot deal with each situation. A preference that is desirable in moderation may not be acceptable when used excessively because excess violates the fundamental fairness in the tax system.

The question is often raised as to whether a minimum tax is appropriate for both individuals and corporations. In my view, a strong case can be made that a minimum tax for individuals is appropriate and necessary to make sure that all individual taxpayers are perceived as paying their fair share of taxes.

In the case of corporations, however, a "fair" share of taxes is a more difficult concept. Although the same basic policy argument may be made for corporations, they do have the ability to plan their affairs in many cases with more flexibility than individuals in order to deal with the minimum tax. At the same time, corporations are subject to fluctuations in income, including possible net economic losses. These considerations make the design of a minimum tax, especially an "alternative" minimum tax, much more difficult for corporations. For example, a major way that a corporation can avoid it is to enter into a consolidation of differently situated companies. Thus, a corporation that is a low effective rate taxpayer and is on the minimum tax may be encouraged to merge with another corporation that is a high effective rate company in order to avoid the minimum tax on a consolidated basis. There is some concern that a minimum tax could actually encourage tax-oriented mergers.

## Background of the Minimum Tax

The minimum tax was first enacted in 1969, as a cornerstone of that year's Tax Reform Act. At that time, the congressional tax-writing committees were concerned about the number of high-income taxpayers -- individuals and corporations -- with little or no tax liability as a result of various tax provisions.

Congress reviewed the existing Code preferences to determine whether they were still appropriate and necessary. Where they could no longer be justified, they were repealed. To the extent Congress determined the provisions served a necessary purpose, but were excessive, Congress cut them back.

In some cases, the use of modified or retained provisions still could produce little or no tax liability for certain taxpayers. In order to increase fairness, the concept of a minimum tax was designed as a "backstop" to the regular tax system. The minimum tax in 1969 was not designed as a revenue-raising measure, but rather as a means to deal with equity and the credibility of our tax system.

Since 1969, the minimum tax has been modified on a number of occasions. In 1976, Congress again sought tax reform and the minimum tax was stiffened and expanded to apply to many more people. Two years later, in 1978, Congress was concerned about the high effective rate on capital gains which, in the extreme case, could have reached almost 50 percent. Congress also was concerned about the effect that the minimum tax had on capital formation in general. As a result, Congress decided to provide more incentives for investment and determined the minimum tax was a disincentive in its present form, thus modifying it to reduce its overall impact.

Since that time, Congress has broadened the minimum tax and strengthened it in both the 1982 and 1984 tax Acts.

## Current Proposals

Attached to my testimony is a chart prepared by Price Waterhouse, summarizing current law provisions and various minimum tax proposals which have been introduced in the 99th Congress. This chart has not been updated to reflect the options now under consideration in the House Committee on Ways and Means. Nor does it reflect a version of minimum tax first offered last year by Senator Chafee and Representative Stark which would disallow a percentage of certain current law provisions -- deductions, credits, and exclusions.

The various proposals currently under consideration would, in large measure, make the minimum tax a very substantial tax. It would become a very significant revenue-raising structure, more than just a means to ensure taxpayers pay their fair share of taxes.

Congress must determine its desired purpose for the minimum tax, how it may affect various taxpayers (both individuals and corporations) and to what extent any cutbacks in a particular preference or the combination with the inclusion of that preference in the minimum tax would discourage the desired activity.

## Specific Considerations

**"Add-on" vs. "Alternative" Minimum Tax:** Another issue that comes into play is whether the minimum tax should be an "add-on" minimum tax or an "alternative" minimum tax. In 1969, Congress enacted an add-on minimum tax, believing at the time that it was appropriate that taxpayers should pay their regular tax and an additional minimum tax on the sum of their preference items. That philosophy shifted in 1978 with respect to individuals, where it was believed that an alternative minimum tax -- whereby an individual would pay the greater of his regular tax or the alternative minimum tax -- was a more appropriate concept. At the same time, the "add-on" minimum tax was continued for corporations.

The "alternative minimum tax" is the approach that is the most consistent with the concept of a minimum tax as a backstop, rather than as a revenue raiser. With this concept, the Code defines two different definitions of taxable income and, in effect, two different tax returns, although there may be many common elements between them. The taxpayer computes both taxes and pays the larger one. Provided that the "minimum tax return" is a full and accurate reflection of current income, the taxpayer will pay at least the rate of tax chosen as the minimum level.

The various proposals being advanced this year propose a shift from the "add-on" to an alternative minimum tax in the case of corporations as well. In the context of today's approach to tax policy with respect to tax reform, it appears to be appropriate for the alternative minimum tax to be applied in the case of corporations, as well as individuals.

## Structure of the Minimum Tax:

The three major elements of the minimum tax are the exemption level, the tax rate, and the base, which includes the preference items. The philosophy of the minimum tax would affect all three in varying degrees, depending on the objectives of the Congress.

**Exemption Level**: The exemption is used to target the minimum tax above a certain level so that taxpayers below that level need never compute the minimum tax. Presently, the exemption is at a $40,000 level for joint returns, and a $30,000 level for single returns.

If a reduction in the exemption level for the minimum tax is used as a means to raise revenue, the consequence would be to impose a minimum tax on people at lower income levels and require many more taxpayers to compute the minimum tax. This would have two effects. First, it may affect people at income levels which should not be subject to a minimum tax and, second, it would add a significant amount of complexity to the tax system. This is because many would be required to compute the minimum tax, even if they are not required to pay it.

**Rate:** The rate of the minimum tax should be set with two purposes in mind. First, it should be set high enough to assure that all taxpayers are, in fact, paying what would be perceived to be a fair share of taxes. At the same time, it should not be so high as to negate the desired effects of the special incentives put into the law to accomplish certain economic, social, and other goals. Also, if the minimum tax rate is too close to the marginal regular tax rate, it would appear that the additional complexity of a second tax system (the minimum tax) would not be worth the effort.

The rate will also determine the appropriate amount revenue that should be generated from a minimum tax. This raises the fundamental purpose of the minimum tax. That is, should the minimum tax be used as a means to ensure all taxpayers pay their fair share and then designed accordingly, or should the minimum tax be used also as a revenue-raising measure which is adjusted to bring a certain revenue level?

The original design of the minimum tax was for the former, that is, to provide credibility to a tax system which allows special preferences for certain goals, but at the same time to make sure that all taxpayers pay their fair share of taxes. Today, it seems that the minimum tax is being looked to equally as a means to raise substantial revenues, as well as to ensure that all taxpayers pay their fair share.

It is my view that revenue considerations should be secondary; the main thrust of a minimum tax should be to ensure that taxpayers do not escape a fair level of taxation.

**Preference Items Included in Minimum Tax Base**: The third major element of the minimum tax is the base -- what preference items should be added back for purposes of minimum tax liability?

For a variety of reasons, Congress has chosen to provide special rules about the taxation of certain sources of income as well as the treatment of certain expenses and deductions relating to various economic activities, preferring to tax some of them less than others where it was believed it was appropriate. Often, the purpose is to provide incentives for activities that are in the broad national interest, such as home ownership, retirement savings, the development of domestic energy, research leading to new technology, or investment in industrial capacity. In other instances, special provisions have been adopted to alleviate potential hardships that may be caused by full taxation or to simplify accounting.

The main purpose of the preference item -- to encourage certain types of activities -- should be reviewed to consider the effect of both the regular tax and the minimum tax as to whether the desired effect is still available. That does not necessarily mean that the items should not be part of the minimum tax, but rather that the amount subject to the minimum tax could be reduced to some extent, depending upon the policy objectives desired by the Congress.

The laundry list of preference items either subject to the present minimum tax or considered for addition to the minimum tax is well known. These are items that have been debated as far back as my earliest days with the Congressional staff. The consideration of these items should take into account the comments I made above with regard to the desired objective of the minimum tax. That is, it should assure that all taxpayers pay their fair share, while at the same time taking into account any consideration of using the minimum tax as a means to raise revenue.

## Other Considerations:

**Complexity**: We should not lose sight of the fact that a minimum tax adds considerable complexity to our tax system. Not only is it a separate system of taxes both for individuals and corporations, but it has different rules for determining the tax base from the regular tax in many situations. In addition, a minimum tax encourages taxpayers to go to great lengths and to use outside professional advice in many cases to make sure that they are subject to the regular tax, rather than the minimum tax.

In fact, it is evident that the minimum tax can put a premium on careful tax planning which often has very little other economic purpose. The minimum tax is a limitation the use of tax incentives. But "limitations" very often have a way of becoming "targets." The normal operation of markets tends to drive down the pre-tax yields of investments or activities that are associated with tax incentives. These investments remain attractive as long as the incentive is effective, but the attractiveness ends once the minimum tax level has been achieved. Hence, the objective of tax planning becomes an attempt to match the minimum tax liability with the ordinary tax liability in every year if possible. This practice helps to sustain the purpose of the tax incentives, but it can use up a lot of scarce talent in the process.

On the corporate side, one of the most common tax planning devices is merger. An alternative minimum tax can add to the current vogue for mergers. Suppose in the absence of the minimum tax that one corporation can achieve an effective tax rate of 15 percent, while another, in an entirely different business, is taxed at 35 percent. If they have equal incomes, a minimum tax of 25 percent would raise their combined average tax rate, as separate taxpayers to 30 percent. As a single consolidated taxpayer, however, the minimum tax would not apply and the merged company would pay tax at only 25 percent. One thing that we have learned lately is that the capital markets can induce mergers to occur as a consequence of quite subtle advantages in financing or taxation.

Many more taxpayers are affected by the minimum tax than simply those actually paying the minimum tax. If a taxpayer may be close to a minimum tax situation, many times he is able to take certain measures in order to avoid the minimum tax and actually pay only the regular tax, but at a level at or just above the minimum tax level. Meanwhile, he may have expended an enormous amount of time in a painstaking exercise to plan his affairs to avoid a minimum tax situation.

While I believe that the concept of a minimum tax adds considerable complexity to the Code, I believe that any complexity resulting from a properly designed minimum tax structure is the price we must pay to ensure that individuals and corporations pay their fair share of taxes.

**Minimum Tax Carryovers:** Some would argue that minimum tax liabilities should be viewed on an annual basis, so that any minimum tax that may be due should apply to that year alone without taking into account any future liability tax consequences or past losses.

This is an especially harsh judgment in the case of corporations. Corporations may be in business cycles or in development plans which would significantly affect their income from year to year. In these cases, they may accumulate certain preferences in one year that may not apply in other years, or alternatively, their incomes may be greater or lesser from year to year depending on business circumstances. In fact, corporations may very well be in real economic loss situations from year to year, in addition to the preference items that they may have. An alternative minimum tax can produce the result that those with fluctuating incomes pay more tax over several years than those with steady income. Switching back and forth between the regular tax and the minimum tax may produce a higher tax burden than staying on one tax or the other.

It is also important to avoid "overdoing it" by taxing the same income in different years. Inevitably, many of the differences between the comprehensive minimum tax base and the ordinary tax base will be differences of timing. Deductions for depreciation will be accelerated for the regular tax but not for the minimum tax, drilling costs may be expensed in one and capitalized in another, profits from contracts may be deferred until completion for the regular tax but taxed as earned under the minimum tax.

The real issue in these "deferral" cases is whether a tax should be applied now or later. If one always pays the larger of the two taxes each year, however, the tax on these items may be paid now and later -- first when the income accrues and again when the same income is realized for the regular tax. It has often been proposed that this problem be solved by allowing the taxpayer to choose to use the minimum tax definition for the regular tax. This solution is technically clever, but it may require very sophisticated tax planning on the part of the taxpayer to determine whether the future switch from the minimum to the regular tax is likely to occur.

The minimum tax under consideration by the Ways and Means Committee does provide that the amount of the minimum tax liability may be carried forward as a credit against regular tax liability in other years. In the case where there is a higher rate for the minimum tax and where the minimum tax is perceived to be more of a revenue-raising measure than in the past, it certainly would appear that this type of carryover provision is appropriate.

**Corporate Tax Preference Cutback**: In the case of corporations, Congress in 1982 enacted section 291 of the Code, which imposes a cutback on the use of certain corporate tax preferences for regular tax purposes. Adjustments are made to the corporate minimum tax to prevent the combination of that tax and the cutback provision from unduly reducing the tax benefit from a preference. An argument can be made that it would be better to use the cutback approach by taking a larger percentage off the availability of the particular tax preference than to use a minimum tax in the case of corporations. On the other hand, this approach would not deal with the concern of a taxpayer stacking too many preferences and thus offsetting its tax liability to an unacceptably low level.

**Prospective Treatment**: Any time there is a significant change in the minimum tax, particularly where new preference are added to the minimum tax base, a very important question arises as to the application of the minimum tax on a retroactive basis. When taxpayers made certain investment decisions that took into account preference items that would affect that decision, it is not appropriate to come at a later date and apply a minimum tax which may have a significant effect on the decision that was made in a prior year.

The fair-share concept is very important but, at the same time, it is necessary to recognize that taxpayers do have a right to rely on the tax law as it existed when they made their investments at an earlier date, taking into account the preference provided by Congress at that time to encourage those incentives.

I am pleased to have had the opportunity to testify before the Committee this morning on the minimum tax. During my 15 years in a tax policy role with the Joint Committee Staff, I have followed the development of the minimum tax in every one of the major tax bills. I have seen the philosophy and concepts change from time to time, depending on the goals sought by Congress at that particular time. It is clear that the structure of the minimum tax is very much affected by the mood of the Congress in connection with the tax effort that is being undertaken. The mood of the Congress presently appears to be directed toward using the minimum tax in large part not only as a backstop to ensure that all taxpayers pay their fair share, but also to a heavier extent as a means to raise revenue to accommodate some of the rate reductions that are associated with this tax reform effort.

Congress should take care in responding to the pressures to raise revenue with a minimum tax. It is important to avoid the complexities, potential inequities, and loss of incentives that can occur with a minimum tax that has high rates and low exemptions, basically to raise revenue.

If I can be of any service to the Committee or the staff during your consideration of this tax reform effort, particularly in consideration of minimum taxes or in any part of your tax reform deliberations, I would be pleased to provide such assistance. Again, it has been a pleasure to be before you again this morning. It brings back many fond memories of the years I sat in this chair under different circumstances.

## MINIMUM TAX PROPOSALS

| **Current Law** | **ADMINISTRATION**<br>May 1985<br>**Provision** | **MOYNIHAN**<br>S 596<br>**Provision** | **BENTSEN**<br>S 973<br>**Provision** | **METZENBAUM**<br>S 663<br>**Provision** | **SCHUMER**<br>HR 2424<br>**Provision** |
|---|---|---|---|---|---|
| **RATE OF TAX** | | | | | |
| 1. **Individuals** | | | | | |
| 20% | 20% | 15% | Not applicable | Not applicable | 25% (phased in from a zero rate to the full 25% between $70,000 and $150,000 of alternative minimum taxable income for individuals (between $70,000 and $150,000 for corporations) |
| 2. **Corporations** | | | | | |
| 15% | 20% | 15% | 15% | 15% | |
| **NATURE OF TAX** | | | | | |
| For individuals, an alternative minimum tax ("AMT") is payable only to the extent it exceeds regular tax; for corporations, the "add-on" tax is payable without regard to regular tax liability | AMT imposed only to the extent it exceeds the taxpayer's regular income tax liability; the total tax due is the greater of the AMT or regular tax | Same as Administration | Individual AMT not addressed; corporate AMT same as Administration | Individual AMT not addressed; corporate AMT, if greater, is paid in lieu of regular tax | Same as Administration |
| **TAXPAYERS SUBJECT TO TAX** | | | | | |
| Individuals subject to alternative tax; corporations subject to "add-on" tax | Individuals and corporations | Individuals and corporations | Corporations | Corporations | Individuals and corporations |
| **COMPUTATION OF TAX BASE** | | | | | |
| A. **General Formula** | | | | | |
| 1. **Individuals** | | | | | |
| AGI, plus preference items, plus NOL adjustments, less AMT itemized deductions, less threshold exemption amount | AGI, plus preference items in excess of $10,000, less AMT itemized deductions, less personal exemptions, less threshold exemption amount | Generally, present law, but not less than an "AMT Income Floor", which is essentially equal to salary plus investment income, less AMT itemized deductions | Not applicable | Not applicable | Present law, with itemized deductions phased out between $100,000 and $150,000 of alternative minimum taxable income ("AMTI") |

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## MINIMUM TAX PROPOSALS

| Current Law | **ADMINISTRATION**<br>May 1985<br>Provision | **MOYNIHAN**<br>S 596<br>Provision | **BENTSEN**<br>S 973<br>Provision | **METZENBAUM**<br>S 663<br>Provision | **SCHUMER**<br>HR 2424<br>Provision |
|---|---|---|---|---|---|
| 2. **Corporations** | | | | | |
| "Add-on" tax imposed on excess of preference items over threshold exemption amount | Regular taxable income (or loss), plus preference items in excess of $10,000, less threshold exemption amount, plus NOL adjustments | Regular taxable income (computed without NOL deduction), plus preference items, less special NOL deduction, less threshold exemption amount | Same as Moynihan | Gross income, plus preference items, less regular deductions except NOL carryover, less special NOL deduction, less threshold exemption amount | Taxable income, plus preference items, plus NOL adjustments, less threshold exemption amount |
| B. **Threshold Exemption Amount** | | | | | |
| 1. **Individuals** | | | | | |
| Joint return: $40,000 | Joint return: $15,000 | Joint return: $50,000 | Not applicable | Not applicable | $70,000 threshold built into rate formula |
| Single return: $30,000 | Heads of households: $12,000 | Single return: $40,000 | | | |
| Other: $20,000 | Single persons: $10,000 | Other: $30,000 | | | |
| 2. **Corporations** | | | | | |
| Greater of $10,000 or regular tax liability | $15,000 | $100,000 | $100,000 | $50,000 | $70,000 threshold built into rate formula |
| C. **AMT Itemized Deductions — Individuals Only** | | | | | |
| o Certain casualty losses<br>o Charitable contributions<br>o Medical expenses<br>o "Qualified interest" (basically home mortgage interest and other interest to the extent of investment income)<br>o The deduction for estate taxes allowed with respect to income in respect of decedents | All itemized deductions except non-business interest (other than on principal residence mortgage) in excess of net investment income | Present law AMT deductions plus income, sales, and property taxes allowable as a regular tax itemized deduction | Not applicable | Not applicable | Present law AMT deductions plus state and local income and real property taxes (with a phase out between $100,00 and $150,000 of AMTI) |

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|---|---|---|---|---|---|
| D. **Net Operating Losses** | | | | | |
| 1. **Individuals** | | | | | |
| Regular tax NOL carryovers are allowed, with adjustments to exclude preference items and permit only the AMT itemized deductions | No provision | Current law provisions generally retained | Not applicable | Not applicable | No provision (present law retained) |
| 2. **Corporations** | | | | | |
| Some or all of the "add-on" tax can be deferred if the taxpayer has a current NOL | Otherwise available NOL deductions would be adjusted with respect to the preference items reflected in NOLs carried over | Otherwise available NOL deductions under §172 would be reduced by the preference items arising in the loss year; carryovers and carrybacks of unused NOLs are permitted, but the amount carried to a particular year is limited to that year's AMTI, rather than regular taxable income as under current law; transition rules are provided for pre-effective date years | Same as Moynihan | Same as Moynihan, except that losses attributable to pre-effective date years would be reduced by the AMT preference items occurring in such prior years to the extent they exceed $10,000 | Same as Moynihan |
| **FOREIGN TAX CREDIT OFFSETS** | | | | | |
| 1. **Individuals** | | | | | |
| A credit is allowed for foreign income taxes paid up to an amount equal to the pre-credit regular and alternative minimum tax times foreign source alternative minimum taxable income divided by total alternative minimum taxable income | [No specific rule provided, but presumably would include provision similar to present law since proposal is based on current law and since a foreign tax credit is contemplated for the corporate alternative minimum tax] | No provision (present law retained) | Not applicable | Not applicable | No provision (present law retained) |

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## MINIMUM TAX PROPOSALS

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|---|---|---|---|---|---|
| **2. Corporations** | | | | | |
| None provided under present law | The foreign tax credit "would be allowed to offset minimum tax liability" | Essentially extends present-law treatment of tax credits for individual AMT purposes to corporations | Foreign tax credits would be allowed, subject to a revised §904 limitation; the alternative minimum foreign tax credit limitation would be the lesser of the regular limitation (as calculated under current law) or an analogous limitation based upon alternative taxable income (i.e., pre-credit AMT times foreign source AMTI divided by total AMTI); sourcing rules analogous to those under present law for noncorporate taxpayers are provided | A special minimum tax foreign tax credit analogous to current law provisions is provided | Present law provisions regarding the creditability of foreign taxes against the noncorporate alternative minimum tax would be extended to cover the new corporate alternative minimum tax |
| **ELECTION OUT** | | | | | |
| Individual taxpayers may elect to deduct certain qualified expenditures ratably over an extended period, with the result that the item will not be deemed a preference item for purposes of the AMT computation | Not included | A taxpayer would be permitted to elect to forgo the preference component of any tax preference item for purposes of computing the regular tax liability, with the result that the item would not be deemed a preference item for purposes of the AMT computation | Same as Moynihan | Same as Moynihan | Generally the same as Moynihan |
| **EFFECTIVE DATE** | | | | | |
| Not applicable | Taxable years beginning after 1985 | Same as Administration | Same as Administration | Same as Administration | Taxable years beginning after date of enactment |
| **REVENUE EFFECT** | | | | | |
| Not applicable | Raise $4.2 billion over five years | Raise $13.5 billion over three years | Revenue neutral; Treasury is directed to compute reductions in the corporate tax rate to offset the additional revenue | Raise $10.5 billion over three years | Raise $22 to $24 billion in first year, with increased revenue thereafter |

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## MINIMUM TAX PROPOSALS

| Code Section & Current Law | ADMINISTRATION May 1985 Provision | MOYNIHAN S 596 Provision | BENTSEN S 973 Provision | METZENBAUM S 663 Provision | SCHUMER HR 2424 Provision |
|---|---|---|---|---|---|
| **PREFERENCE ITEMS** | | | | | |
| **A. Current Law** | | | | | |
| **Sec. 116**<br>**Exclusion of dividends received by individuals [57(a)(1)]***<br>Preference equal to the amount of dividends excluded by an individual from taxable income (Individual Only) | Not included | Specifically repealed (I) | Not included | Not included | Retained unchanged (I) |
| **Sec. 167**<br>**Accelerated depreciation on real property [57(a)(2)]***<br>Preference equal to excess accelerated depreciation over straight line for non-recovery real property (Individual and Corporate) | Retained unchanged (I) | Retained unchanged (I) | Retained unchanged | Retained unchanged | Retained unchanged (I) |
| **Sec. 167**<br>**Accelerated depreciation on leased personal property [57(a)(3)]***<br>Preference equal to excess accelerated depreciation over straight line for non-recovery leased personal and other §1245 property (Individual Only) | Retained unchanged (I) | Retained unchanged (I) | Not included | Not included | Current provision modified to include excess accelerated depreciation on all nonrecovery personal property (not just leased) and extended to corporations as well as individuals (I) |
| **Sec. 169**<br>**Amortization of certified pollution control facilities [57(a)(4)]***<br>Preference equal to the excess deduction allowable under §169 over the amount that would be allowable under §167 (Individual and Corporate) | Retained unchanged (I) | Retained unchanged (I) | Preference equal to the excess deducted under §169 over an amount based on a straight-line recovery method using an extended economic life | Retained unchanged | Retained unchanged (I) |

* Current minimum tax preference item.
(I) Preference also applicable to individuals.

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## MINIMUM TAX PROPOSALS

| Code Section & Current Law | ADMINISTRATION | MOYNIHAN | BENTSEN | METZENBAUM | SCHUMER |
|---|---|---|---|---|---|
| | May 1985 | S 596 | S 973 | S 663 | HR 2424 |
| | Provision | Provision | Provision | Provision | Provision |
| **Sec. 616/617**<br>**Mining and exploration and development costs [57(a)(5)]***<br>Preference equal to the amount deducted under §§616(a) and 617 over that allowed as a ratable deduction over 10 years (Individual Only) | Current provision made applicable to corporations (I) | Same as Administration | Same as Administration | Current provision made applicable to corporations, with the excess based on a 120-month recovery period from when expenditures were made rather than the current 10 years beginning in year in which expenditures made | Same as Administration |
| **Sec. 173**<br>**Circulation expenditures [57(a)(6)]***<br>Preference equal to the amount deducted under §173 over what would be allowed as a ratable deduction over 3 years (Individual Only) | Specifically excluded as a preference item for corporations and individuals (I) | Current provision made applicable to corporations (I) | A preference equal to the amount deducted under §173 | Not included | Current provision made applicable to corporations (I) |
| **Sec. 174**<br>**Research and experimental expenditures [57(a)(6)]***<br>Preference equal to the amount deducted under §174 over what would be allowed as a ratable deduction over 10 years (Individual and Corporate) | For personal holding companies only, a preference equal to the excess of the deduction for the taxable year for research and experimental expenditures over the amount that would have been allowed had such expenditures been amortized over a 10-year period (I) | Current provision made applicable to corporations, with the current amortization period for computing the excess reduced from 10 to 5 years (I) | Same as Moynihan | Not included | Same as Moynihan for corporations. Individual preference retained at 10 years (I) |
| **Sec. 585/593**<br>**Reserves for losses on bad debts of financial institutions [57(a)(7)]***<br>Preference equal to the amount deducted under the reserve method over actual experience (Corporate Only) | Not included | Application extended to all taxpayers using the reserve method (I) | Retained unchanged | Not included | Retained unchanged |

* Current minimum tax preference item.
(I) Preference also applicable to individuals.

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|---|---|---|---|---|---|
| **Sec. 611 Depletion [57(a)(8)]*** Preference equal to the amount deducted under §611 over the adjusted basis of the property at year end determined without regard to the depletion deduction (Individual and Corporate) | Present law retained unchanged for depletable property placed in service before 1986; for property placed in service after 1985, a preference equal to the excess percentage depletion allowed over that which would have been allowed as cost depletion (I) | Retained unchanged (I) | Retained unchanged | Retained unchanged | Retained unchanged (I) |
| **Sec. 1201/1202 Capital gains [57(a)(9)]*** For noncorporate taxpayers, a preference equal to the net §1202 capital gain deduction; for corporations, a preference equal to the rate differential for net §1202 capital gains | For corporations, a preference equal to the income effectively untaxed due to preferential capital gains treatment; for individuals, the net capital gain deduction (I) | Retained unchanged for individuals; not included for corporations (I) | Not included | Not included | Retained unchanged (I) |
| **Sec. 422A Unrealized gain on exercise of incentive stock option [57(a)(10)]*** Preference equal to the excess of FMV over option price at the time of exercise | Retained unchanged (for noncorporate taxpayers only) (I) | Retained unchanged (for noncorporate taxpayers only) (I) | Not included | Not included | Retained unchanged (for noncorporate taxpayers only) (I) |
| **Sec. 263(c) Intangible drilling costs [57(a)(11)]*** Preference equal to the excess of IDCs over net income of the taxpayer from oil, gas, and geothermal properties (Individual Only) | Current provision made applicable to corporations, with preference equal to 8% of the costs paid or incurred during the year | Current provision made applicable to corporations, but modified with excess IDC based on 120-month amortization without current offset for oil and gas income (I) | Current provision made applicable to corporations | Current provision made applicable to corporations, with excess "computed on a straight-line basis over a period of 120 months" | Current provision made applicable to corporations, with excess IDC based on that amount permitted as a capitalized expense without current offset for oil and gas income (I) |

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* Current minimum tax preference item.
(I) Preference also applicable to individuals.

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|---|---|---|---|---|---|
| **Sec. 168**<br>**Accelerated cost recovery deduction**<br>**[57(a)(12)]***<br>For recovery property (except 18-year real property and low-income housing) subject to a lease, a preference equal to the excess of ACRS deductions over what would be allowed on a straight-line basis over an extended period of up to 22 years for 15-year public utility property (Individual Only)<br>For 18-year real property and low-income housing, a preference equal to the excess ACRS deduction over what would be allowed on a straight-line basis (Individual and Corporate) | Retained unchanged for recovery property which is either 15-year or 18-year real property, or low-income housing; for real property subject to CCRS, a preference equal to the amount by which the CCRS deduction exceeds the depreciation that would have been allowed under rules similar to the November 1984 Treasury proposal (I)<br>For leased property placed in service before 1/1/86, the current provision is retained unchanged for individuals and applicable only to corporations which are personal holding companies (PHCs); for leased personal property placed in service after 1985, a preference for individuals and PHCs equal to the amount by which the CCRS deduction exceeds the depreciation that would have been allowed under rules similar to the November 1984 Treasury proposal | Current provision made applicable to corporations and modified to include excess ACRS on all recovery property; the comparison recovery period for computing the excess is increased for all classes of recovery property to their present-law §312(k) earnings and profits lives (from 5 years for 3-year property to 40 years for 18-year real property and low-income housing) (I) | Same as Moynihan, but with shorter comparison lives for computing the excess deductions -- the recovery period for low-income housing would be increased from 15 years to 18 years; other real property remains at 18 years | Current provision made applicable to corporations | Current provision modified to include excess ACRS on all recovery property and extended to corporations as well as individuals; the excess ACRS is calculated by reference to the deduction that would be available using the straight-line method over the property's present class life [as defined in §168(g)(2)] or 12 years if none; for real property, the excess would be based on an extended 40-year recovery period (I) |
| **B. Proposed New Items** | | | | | |
| Sec. 103<br>**Tax-exempt income** | Not included | Not included | Not included | Not included | A preference equal to all tax-exempt income received or accrued on newly-issued tax-exempt securities (I) |

* Current minimum tax preference item.
(I) Preference also applicable to individuals.

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|---|---|---|---|---|---|
| Sec. 133<br>**Interest excluded on loans used to acquire employer securities for ESOPs** | Not included | A preference equal to excluded interest income received on loans to acquire employer securities | Not included | Not included | Not included |
| Sec. 163<br>**Interest expense deduction** | A preference equal to 25% of the deduction for interest expense for the taxable year (reduced by taxable interest income for such year), but not in excess of the amount (if any) by which the deduction allowed under CCRS for each item of personal property placed in service after 1985 (but, in the case of personal holding companies, only if such property is not subject to a lease), exceeds the deduction that would have been allowed under rules similar to the November 1984 Treasury proposal | Not included | Not included | Not included | Not included |
| Sec. 170<br>**Charitable contributions** | A preference equal to the excess of charitable contribution deduction allowed over the donor's basis in the donated property (1) | Not included | Not included | Not included | Not included |
| Sec. 177<br>**Trademark and trade name expenditures** | Not included | A preference equal to the amount allowed as a deduction under §177 (1) | Same as Moynihan | Not included | Not included |

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(1) Preference also applicable to individuals.

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|---|---|---|---|---|---|
| **Sec. 182/194 Reforestation and land clearing expenses** | Not included | A preference equal to the amount deducted under §§182 or 194 (I) | Not included | Not included | Not included |
| **Sec. 189/312 Construction period carrying charges** | Not included | A preference equal to all interest, property taxes, and similar construction costs deducted for the year (I) | Same as Moynihan | Not included | Not included |
| **Sec. 193 Tertiary injectant expenses** | Not included | A preference equal to excess of the amount deducted over the straight-line amount based on a 24-month amortization period (I) | Not included | Not included | Not included |
| **Sec. 248 Organizational expenditures** | Not included | Not included | A preference equal to the amount deducted under the optional 60-month amortization provision of §248 | Not included | Not included |
| **Sec. 265 Certain interest expense where taxpayer has tax-exempt income** | Not included | A preference equal to interest expense paid or accrued, but not to exceed annual tax-exempt interest income reduced by any interest deduction forgone under §265 (I) | A preference equal to a specified percentage of interest expense determined by the ratio of tax-exempt receipts over gross receipts, applied on an affiliated group basis | A preference equal to the deduction currently permitted under §265(2) for financial institutions with respect to interest received on tax-exempt obligations | A preference equal to the deduction allowed financial institutions for interest expense incurred to purchase or carry tax-exempt obligations issued after date of enactment |
| **Sec. 451 Completed contract method of accounting** | Not included | A preference equal to the excess of taxable income that would have been reported under the percentage of completion method of accounting over the taxpayer's taxable income for the year (I) | Same as Moynihan | A preference equal to the deduction for "certain indirect costs" to the extent that it exceeds the amount that would have been allowable if such costs had been capitalized and deducted under the "progress payment method" | Same as Moynihan |
| **Sec. 453 Gain on installment sales** | Not included | Not included | Not included | Not included | A preference equal to the amount of gain deferred on sales during the year through use of the installment method (I) |

(I) Preference also applicable to individuals.

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|---|---|---|---|---|---|
| **Sec. 806(a) & (b) Life insurance company deductions** | Not included | A preference equal to the deductions allowed under §806(a) & (b) | Same as Moynihan | Not included | Same as Moynihan |
| **Sec. 923 Exempt foreign trade income** | Not included | A preference equal to the excluded FSC income after application of the current preference cutback rules of §291 | Same as Moynihan | A preference equal to the "increase in accumulated DISC or FSC income for the taxable year" | A preference equal to a FSC's exempt foreign trade income under §923(a) |
| **Sec. 1272/1274 Original Issue Discount (OID)** | Not included | Not included | Not included | With respect to issued OID bonds, the excess interest deducted under the ratable accrual method over what would have been deductible under an economic accrual concept [provision may be stricken as unnecessary after DEFRA] | Not included |
| **Sec. 266 of ERTA Motor carrier operating authorities** | Not included | Not included | Not included | A preference equal to amounts deducted under §266 of ERTA | Not included |
| **"Inside buildup" of life insurance contracts and annuities** | Not included | Not included | Not included | Not included | A preference equal to the excess of the sum of any change in cash surrender value, withdrawals, the cost of current insurance protection, and policyholder dividends paid during the year over premiums paid during the year (I) |
| **Shipping income** | Not included | A preference equal to the annual income and capital gains increases in reserve and capital construction funds established under §§511 and 607 of the Merchant Marine Act (I) | Same as Moynihan | Same as Moynihan | Same as Moynihan, except not applicable to amounts earned on funds deposited in a capital construction fund before 5/8/85 |

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(I) Preference also applicable to individuals.

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Senator **Moynihan**. Two excellent points. Speaking as someone who is not a lawyer—and we have two law professors with us today—could anybody explain to me the difference between 'law' and 'equity?' Apparently we have two systems of law. I always thought we had only one.

I would reiterate Mr. Shapiro's view that we should not extend the minimum tax to so many taxpayers that we have, in effect, two tax systems, perhaps not all that far apart—as could occur if marginal rates are reduced even further.

Mr. **Shapiro**. Well, Senator, as you know, this whole effort started with simplification.

Senator **Moynihan**. Yes, something we last saw perhaps 1,700 pages of the Tax Code ago.

Mr. **Shapiro**. That's correct.

And at this point when the rates were at a very high level, when they were at 70 percent, when the minimum tax first came in, the corporate rate was 46 percent. When you had a 10-percent and a 50-percent rate, you had it, depending on where the exemption level was, you were focusing on preferences of people who really avoided paying their fair share of taxes.

As the regular rate comes down and the minimum tax rate goes up, and exemption level is reduced and more preferences are added, you are coming very close to having two systems that many taxpayers would have to fill to see which is the greater tax, and it adds in complexity. And that is a factor that has to be taken into account.

Senator **Moynihan**. Gotcha, gotcha. Let's go on from there.

Professor Graetz of Yale. Welcome, sir.

## STATEMENT OF PROF. MICHAEL J. GRAETZ, PROFESSOR OF LAW, YALE UNIVERSITY, NEW HAVEN, CT

Professor **Graetz**. Thank you, Mr. Chairman. It's a pleasure to be here.

My involvement with the minimum tax began with my time at the Treasury Department in 1969 when I worked on the provisions that ultimately were enacted as the first minimum tax, and I have been concerned with minimum taxes ever since.

Let me say that the 1982 amendments to the individual minimum tax, it seems to me, restored much of its original concept as providing an insurance mechanism that high-income individuals would pay some tax. I think there are improvements that could be made to the individual minimum tax, but it seems to me that the appropriate structure of the individual minimum tax is now in place.

I have never been a fan of add-on minimum taxes. I think they were added on the Senate side in 1969 largely because——

Senator **Moynihan**. Would you mind defining "add-ons?"

Professor **Graetz**. Well, an add-on minimum tax, such as now applies to corporations, is a minimum tax that applies in addition to the regular income tax, whereas an alternative minimum tax, is one that applies in lieu of the regular income tax, and applies only when the minimum tax would be higher than the regular income tax.

So I think what I will do is devote my time to the corporate minimum tax, although my statement includes some discussion of the individual minimum tax as well.

I think in the individual minimum tax there really are only two things that really need to be considered. One is whether there are additional items that should be added to broaden the mimimum tax base that are not now included; and, second, whether there should be some mechanism added to the individual minimum tax to limit tax shelter losses. But I will save those issues until our panel discussion.

Let me turn to a corporate minimum tax. Inherently a corporate minimum tax is less defensible in theory than an individual minimum tax because a corporate minimum tax does not link as directly as an individual minimum tax to low-tax, high-income taxpayers. The shareholders of the corporation determine whether the tax will be paid by high- or low-income shareholders.

That is one of the reasons that the Treasury in 1969 did not recommend a minimum tax for corporations and one of the reasons that the minimum tax for corporations has been something of a stepchild of the minimum tax debates. It seems to me that we are now at the point where there are so many ways for corporations to avoid tax that the spectacle of high-income, low-tax corporations is no longer acceptable within the Federal tax system. Therefore, we need to do something directly to respond to that problem.

The something, it seems to me, is necessarily an alternative minimum tax for corporations. It is true that an alternative minimum tax creates certain inefficiencies. You will hear from many economists that a corporate minimum tax will mean that some taxpayers can use preferences and others cannot and that that is economically inefficient. And you will hear that a minimum tax says to taxpayers: Use tax loopholes and preferences that we have provided against the top rates, but when they become cheap to the Government, say, down at a 20- to 15-percent level, you must stop using them, and pay a minimum tax.

Nevertheless, I think that a minimum tax is essential for fairness purposes, and we will have to accept the inefficiencies that might result from a minimum tax.

Let me make three points about the structure of a corporate minimum tax that have not, generally, been made, to my knowledge. First, all of the proposals that I have seen begin with taxable income and then add back a list of preferences. The list of preferences, as you know, Senator, differs from bill to bill. My suggestion to the committee is that perhaps you should start with gross income and then ask what deductions should be allowed for minimum tax purposes. At a minimum, I think you will find that the corporations will be more helpful to you in pointing out the deductions that should be allowed than they are likely to be in pointing out to you the preferences that need to be added back to the base. You might get more help from the outside world by starting with gross income.

Senator MOYNIHAN. A voice of experience has just been heard in this committee room. [Laughter.]

Professor GRAETZ. If I could just make two more points.

Senator MOYNIHAN. Oh, please.

Professor **GRAETZ**. I see my time is up.

Senator **MOYNIHAN**. That's sort of just a guideline. [Laughter.]

Professor **GRAETZ**. That's the way it is in my classroom as well. [Laughter.]

Second, I think the committee ought to give serious consideration to applying a corporate minimum tax on a line-of-business by line-of-business basis and not allow the use of losses from one business to offset gains from another corporation. I know that is a fairly provocative proposal, but, at a 20-percent rate, it seems to me that it might serve to make the minimum tax more effective and could restrict the ability of corporations—through mergers or through the creation of tax loss subsidiaries—to avoid not only the regular income tax but also the corporate minimum tax.

Third, the committee ought to give consideration to using domestic profits reported to shareholders and creditors for book purposes as a floor on the minimum tax. All of the public documents that relate to the public the existence of high-income corporations who pay little or no tax, use book profits as a measure of income for that purpose. If the committee structures a minimum tax which pays no attention to the amount of book income that is reported by these corporations, then, even after you enact a minimum tax, you will still have the spectacle of corporations with large amounts of domestic book profits who pay no minimum tax and no regular tax.

Domestic book profits could be used as a minimum tax base floor without adding great complexity to the minimum tax since companies routinely measure book profits for nontax reasons.

The final point I would make is that looking at minimum tax revenues is deceptive. The minimum tax not only raises revenue in its own right, but it serves as a floor on the revenues that will be paid under the regular income tax. There are many individuals today who pay regular income taxes, not minimum taxes, because they are very close to the floor. And if you enact a corporate minimum tax, the same thing will be true. It is just an accident of accounting that regular income taxes never count as revenues raised by the minimum tax. A properly structured alternative minimum tax that provides a floor to tax avoidance can be an important insurance policy in this tax reform effort.

Senator **MOYNIHAN**. That was a nice point because, as you know, it has been estimated that the bill Senator Chafee and I introduced would pick up about 4½ billion per year. But what you are saying is that the true revenue gain would be higher. I believe Dr. Gutman agrees with me.

Dr. **GUTMAN**. Yes.

[The prepared written statement of Professor Graetz follows:]

# STATEMENT
# OF
# MICHAEL J. GRAETZ

Professor of Law
Yale Law School

on the Subject of the Minimum Tax

before the

SENATE COMMITTEE ON FINANCE

OCTOBER 9, 1985

Mr. Chairman and Members of the Committee:

It is a great pleasure to appear before you today to discuss minimum taxes for individuals and corporations.

The minimum tax is a subject that has concerned me since I worked for the Treasury Department on the first minimum tax provisions enacted by Congress in the Tax Reform Act of 1969. Since that time, the minimum tax concept has frequently been a tax reform showpiece for leaders of both political parties.

The minimum tax for individuals went through three major revisions since its enactment in 1969. The 1982 amendments to this minimum tax provision not only restored much of its original conception, but, as I have argued elsewhere,* also restructured the minimum tax so that it might become a mechanism for easing the transition generally to a broad-based low rate income tax.

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* I made this argument in an article that appeared in the University of Southern California Law Review entitled "The 1982 Minimum Tax Amendments as a First Step in the Transition to a 'Flat Rate' Tax," 56 S. Cal. L. Rev. 527 (1983).

In contrast, the corporate minimum tax provisions have never quite overcome their uncertain beginnings; they are not yet capable of serving their necessary protective function for the corporate income tax, nor are they so designed to create a satisfactory transitional mechanism for moving to a broader based lower rate corporate tax. There is far more work needed to be done by Congress with respect to the corporate minimum tax than the individual minimum tax.

Before turning to specific minimum tax issues, let me briefly review the justification for and inherent weaknesses of a minimum tax provision.

## Absent a Comprehensive Tax on Economic Income, Only Individual and Corporate Minimum Tax Provisions Can Protect Against Widespread Perceptions that the Income Tax is Unfair.

Minimum taxes serve to bridge two conflicting goals which characterize our income tax.

If the income tax were limited to its principal function, and simply taxed individuals and corporations in accordance with their economic income, so that taxpayers with similar amounts of income routinely paid similar amounts of tax, there would be no need for a minimum tax provision.

As we all know, however, the income tax is also routinely used as an instrument of economic and social policy and provides a wide variety of incentives or "tax preferences" for particular kinds of activities. An income tax which provides even a limited number of special exclusions, deductions and tax credits that enable taxpayers to reduce taxable income below their net economic income and their tax liabilities below that paid by taxpayers with similar amounts of economic income will necessarily produce large tax reductions for corporations and individuals who take great advantage of tax preference opportunities. This, in turn, produces the spectacle of significant numbers of high income individuals and corporations paying little or no tax.

In 1969, Secretary of the Treasury Joseph Barr's announcement that 154 taxpayers with $200,000 or more of adjusted gross income paid no income tax generated more letters to the Congress than were received that year on any other subject, including the war in Southeast Asia. However, the phenomenon of high-income-low-tax individuals and corporations seems to have lost much of its power as a galvanizing force of public support for tax reform. Today such announcements are not met with spontaneous public outbursts of dismay and rage.

For example, the recent report that 129 large corporations paid no income taxes in at least one of the four years from 1981 to 1984 -- even though they earned a total of $66.5 billion in pre-tax domestic profits in the years they paid no tax -- did not seem to produce a grass roots groundswell for tax reform. The public today seems almost to expect news of this sort.

Many observers of the tax system, including several former Commissioners of Internal Revenue, seem to believe that, rather than writing their representatives and senators, the citizenry now expresses its outrage at the unfairness of the income tax by finding ways -- both legal and illegal -- to reduce their own tax burdens.

Regardless of the actions of the populace with respect to such news, the Congress can take only one action to prevent individuals and corporations paying little or no taxes on significant amounts of economic income. That is to enact effective minimum tax provisions that ensure that both individuals and corporations with substantial amounts of economic income will pay at least some minimum amount of income taxes as their contribution to the financing of government.

## A Minimum Tax Necessarily Produces Certain Inefficiencies -- This is a Necessary Price for Improving the Public's Perception That the Tax System is Fair.

A minimum tax is necessarily a compromise between completely eliminating tax preference provisions from the income tax and allowing them to be used without limitation. As such a compromise, a minimum tax necessarily entails costs.

You will hear that the minimum tax produces economic inefficiencies. This is true. A minimum tax provision necessarily discriminates among those individuals and corporations who remain eligible to use tax preference provisions without incurring its costs and those who are considered already to have enjoyed enough tax reduction through such preferences and therefore will be precluded further from using preferences without paying a minimum tax.

The most obvious inefficiency inherent in using a minimum tax to combat the problem of perceived income tax unfairness is that the government, in effect, will be saying to taxpayers:

"Use our tax incentives and tax preferences when they are most costly to the government, -- when they offset income that would be taxed at the top rate (today 46 or 50%) -- and stop using these preferences when they would be least costly to the government -- when they would, absent a minimum tax, offset income that would otherwise be taxed at rates ranging downward from 20% to zero. Congress simply must accept such costs of a minimum tax as a necessary consequence of its continuing desire to use the income tax as an instrument of economic or social policy.

To be sure, a compromise such as a minimum tax has inherent weaknesses and inefficiencies. But Congress should be very cautious about attempting to structure a tax system -- even for corporations -- that is responsive solely to arguments grounded in considerations of economic efficiency. The decision to tax income necessarily requires acceptance of some economic inefficiency because fairness in taxation demands it. On balance, effective individual and corporate minimum taxes will strengthen the income tax. Perhaps they will also bring us closer to the day when the tax will be imposed on economic income.

## The Individual Minimum Tax is in Pretty Good Shape.

Under current law, the individual minimum tax imposes a flat 20% tax on a broadened income tax base and is required to be paid whenever it exceeds the regular income tax. Persons might quarrel with the minimum tax exemption level, its list of tax preferences or its rate, but the individual minimum tax generally serves to broaden the income tax base to increase taxes of high-income individuals who Congress has concluded might otherwise avoid paying their fair share of taxes under the regular income tax rules.

The individual minimum tax provisions treat capital gains and ordinary income equally, treat itemized deductions in a manner generally consistent with broad-based income tax principles, and restrict significantly the allowance of tax credits. The minimum tax provisions applicable to individuals include many important tax deductions and exclusions in the base, for example, percentage depletion and intangible drilling expenses, mining exploration expenses and accelerated depreciation on real estate.

The principal task of the Congress in its current legislative revision of the individual minimum tax should be to add a number of currently excluded items to the minimum tax in an effort to achieve as comprehensive a minimum tax base as is practical. The most obvious candidate for inclusion is, of course, interest on state and local bonds. Such tax exempt interest was among the items of tax preference in the minimum tax proposals of both the Johnson and Nixon Administrations in 1969 and was included as a preference in the House version of the 1969 Tax Reform Act. It was also included as a tax preference in the Senate version of the 1982 legislation, but has never emerged on a list of minimum tax preferences approved by a House-Senate conference. Without tax-exempt interest in the minimum tax base, high income taxpayers are routinely able to avoid paying federal income taxes.

Other exclusions and deductions should also be added to the minimum tax base, but rather than detailing these in my prepared statement, I shall discuss these in response to questions. However, one major structural point merits specific attention.

## Limiting Tax Shelters to Related Income.

The individual minimum tax does not now serve as an effective limit on the use of tax shelters. This Committee has before it a number of specific proposals that would address the tax shelter issue, but it seems to me that, even if a number of the other specific measures are adopted, one amendment to the minimum tax deserves serious consideration.

Any minimum tax, if it is to be effective, should limit the use of losses, particularly tax shelter losses, to offset unrelated income. A provision should be added to the minimum tax that would allow deductions from tax shelter investments, and perhaps investment losses generally, to offset only income related to the investment. This approach is now found in the minimum tax rules that limit deduction of interest to net investment income, and close analogies are contained in current law limitations on deductions for so-called hobby losses and vacation homes. A general proposal of this sort was included in the 1973 tax reform proposals of the Nixon Administration, and a limitation on the deduction of tax shelter losses was contained in the House version of the 1976 Tax Reform Act, but no such limitation on losses has ever been enacted. Such a provision -- either under the regular income tax rules or at least in the minimum tax -- seems essential to achieve an effective limit on the ability of high income individuals to use tax shelter losses to offset unrelated income.

## The Minimum Tax for Corporations Needs Major Restructuring

### An Effective Corporate Minimum Tax Has Become Essential

In 1969, the enactment of a minimum tax for corporations did not enjoy the same kind of support as a minimum tax for individuals. Neither the Treasury Departments of the Johnson or Nixon Administrations had proposed or supported a corporate minimum tax, and no corporate minimum tax provision was contained in the House version of the 1969 act. The Senate bill in 1969, however, did contain the corporate minimum tax provision that became the statutory origin of the present law provision. This corporate minimum tax was enacted principally to make up the revenue loss that would otherwise have occurred from the Senate's restructuring of the House minimum tax provisions. As was originally true with the individual minimum tax, the corporate minimum tax is a "add-on" minimum tax, rather than an alternative minimum tax.

It is true that, as a conceptual matter, a minimum tax on corporations is not as easy to defend as an individual minimum tax. That is because high economic income of a corporation does not correlate to ability to pay as readily as does high economic individual income. Whether the existence of high economic income of a corporation that pays little or no tax represents tax avoidance by high income individuals will depend upon the income tax brackets of the corporation's shareholders.

On the other hand, widespread avoidance of tax on economic income by corporations undercuts the basic corporate income tax function of assuring that undistributed corporate income will be subject to income tax.

In light of the great flexibility as to the legal form of business enterprise that may be selected in this country, it is essential that the corporate income tax not simply become an escape hatch for avoiding individual income taxes.

Great concern has recently been expressed about the widespread variations in effective rates of corporate income tax -- variations that occur both across industries and among companies within the same industry. Indeed, the President's proposals to repeal the investment tax credit and replace the ACRS system of depreciation are principally intended as a response to such disparities. But the combination of ACRS depreciation and investment tax credits are not a full explanation for the wide differences in effective corporate tax rates. Variations in the extent of debt financing, variations in each company's history of gains and losses, and variations in accounting practices may also produce widely disparate corporate tax burdens.

These disparate tax burdens among industries and among companies within a single industry produce enormous misallocations of resources that cannot be explained as any sort of coherent national industrial policy. Reducing such tax-induced distortions, and the losses they cause in economic efficiency, is probably the principal goal of the wide platter of business tax reform measures now before the Congress. By placing a floor on the effective income tax rate applicable to corporate economic income, an effective corporate minimum tax provision might serve a significant function in reducing such disparities.

Moreover, the ability of large corporations with substantial amounts of economic income to arrange their affairs so that they pay little or no corporate income tax is a major contributor to citizens' perceptions that the current income tax is unfair. Regardless of theoretical niceties, it is simply impossible for a low or moderate income worker to understand why the large corporation for which he or she works should pay taxes on a huge amount of economic income at a far lower rate than applies to the workers' salaries.

The conditions that today cry out for an effective corporate minimum tax simply did not exist to a similar extent in 1969. In 1969, the corporate income tax accounted for about 20% of federal revenues; by contrast, in 1983, the corporate income tax accounted for only 6.3% of federal revenues. Opportunities for corporations to avoid federal income taxes are far more prevalent today than in 1969. The current corporate income tax is not projected to produce more than about 10% of federal revenues for any year for which projections have been made.

The declining share of taxes paid by corporations, in combination with widespread reports of huge corporations paying little or no tax, accounts to a great extent for widespread perceptions that the income tax is unfair. The Congress simply cannot fail to address the problem of corporations with high economic income paying little or no tax if it is to be regarded by the American people as having moved in this tax reform legislation in the direction of genuine income tax reform. In the absence of a corporate income tax that comprehensively taxes economic income, a minimum tax on corporations now seems essential.

Let me now turn to some of the more important structural issues in designing such a corporate minimum tax.

## To be Effective, A Corporate Minimum Tax Must Be An Alternative Tax, Not an Add-On Tax

The corporate minimum tax is a tax of 15% on certain corporate tax preferences to the extent that these preferences exceed the greater of the corporation's regular income tax or $10,000. An additional corporate minimum tax of this sort serves to reduce directly certain corporate tax preferences. The offset for the corporation's regular income taxes does provide some linkage with a company's overall use of tax preferences, but does not provide the kind of direct connection with a corporation's overall economic income that would be possible with an alternative corporate minimum tax.

Shifting from an add-on to an alternative corporate minimum tax now seems to have widespread bipartisan support. Only an alternative minimum corporate minimum tax can effectively serve the function of requiring corporations with significant amounts of economic income to pay some minimum share of income taxes and thereby serve the function of setting a floor on corporate tax avoidance as a way of redressing widespread perceptions of income tax unfairness. An add-on corporate minimum tax is simply not up to this task.

## Constructing An Alternative Corporate Minimum Tax

This committee has before it a variety of specific proposals for structuring alternative corporate minimum tax provisions, including one by the President. I shall not in my prepared statement today attempt to discuss these proposals in any detail, nor shall I attempt here to delineate a list of corporate tax preferences that I would consider most appropriate for inclusion in an alternative minimum tax. I will be happy to answer any questions that the committee might have in this regard. I do, however, wish to raise some general structural issues here.

## The Corporate Minimum Tax Base Should Be As Broad As Is Practical.

To be effective, a corporate minimum tax must necessarily cast a wide net. Even if there exists legitimate dispute about whether a particular corporate tax provision should appropriately be labeled a tax preference, the fundamental principle in structuring a corporate minimum tax base should be inclusion unless there is a compelling reason for exclusion. This means, for example, that -- regardless of the compromises adopted for purposes of the regular corporate income tax -- deductions for business entertainment, business meals, and business travel should be severely curtailed under a corporate minimum tax.

Moreover, the President's proposal seems correct in its conclusion that the problem of debt financing by corporations must be addressed by a corporate minimum tax.

The same amount of corporate minimum tax revenue can be raised with lower rates applied to a broader base than with higher rates on a narrower minimum tax base. Without a broad corporate minimum tax base, it seems extremely unlikely that public reports of high income corporations that pay little or no tax will cease in the future.

## Try Beginning With Gross Income Rather Than Taxable Income.

Every corporate minimum tax proposal now before this committee adds a list of tax preferences to corporate taxable income. This committee should consider structuring an alternative corporate minimum tax by beginning from the opposite direction -- start with gross income and develop a list of deductions that you agree should be allowed for minimum tax purposes. This approach seems far more likely to produce a comprehensive corporate minimum tax than does a debate over which tax preferences should be added back to taxable income.

At a minimum, you would undoubtedly find that corporations themselves will prove far more helpful in identifying exclusions, deductions and credits that they think should be allowed for minimum tax purposes than they are likely to be in identifying additional preferences to be added to taxable income. A presumption that an exclusion, deduction or credit will not be allowed unless a compelling case is made for its allowance should be the guiding principle of the committee's deliberations.

## Losses Should Not be Allowed Against Unrelated Income.

A corporate minimum tax should apply line of business by line of business; regular corporate income tax rules that allow losses to be offset against unrelated income from a different line of business should be avoided for minimum tax purposes. It has simply become too easy for corporations to create tax loss subsidiaries to expect a corporate minimum tax to be effective without restricting the use of such losses.

Beginning in the early 1980's, in connection with the liberalization of depreciation allowances, companies have routinely argued that tax losses should be available on a more liberal basis. The concept of "free transferabilty" of tax losses apparently reached its zenith with the enactment of the so-called "safe-harbor leasing provisions" of the 1981 legislation that permitted one company -- through the use of an artificial document entitled a "lease" -- to transfer tax deductions and credits to another company in exchange for cash. However, subsequent cutbacks on safe-harbor leasing and tax exempt leasing have not eliminated the problems.

Corporations today are routinely able to shift tax benefits to one another through leasing arrangements. Economists argue that such free transferability of tax losses produces advantages to the country in terms of economic efficiency. But such free transferability produces at least equally great disadvantages in terms of citizens' perceptions that the income tax system is fundamentally unfair.

Free transferability of tax deductions through leasing transactions or other mechanisms essentially converts the government into an automatic joint venturer in all business endeavors -- a 46% partner -- without the participation in corporate management and decisionmaking generally accorded to important joint venturers.

To be effective, a minimum tax provision must restrict opportunities for utilization of such tax losses; the consolidated tax return mechanism which allows tax losses of one company to offset tax gains of a related company should not be available for minimum tax provisions. The rules regarding the economic substance and commercial reality required to allow leasing transactions to produce useable tax losses should be tightened substantially -- at least under the minimum tax. A corporate minimum tax must necessarily adopt the premise that an income tax is a taking by the government of at least a minimum share of the earnings of successful business ventures, not an occasion for government partnership with unsuccessful ones.

## Domestic Corporate profits Reported for Book Purposes Should Be Used As A Minimum Tax Floor

Domestic corporate profits reported on a corporation's books for financial reporting to creditors and shareholders should be used as a floor for the corporate minimum tax base.

None of the corporate minimum tax proposals advanced to date would connect the corporate minimum tax directly to the amount of income reported by corporations to shareholders. This is true even though all of the public reports about high-income low-tax corporations involve a comparison between federal income taxes and book income.

Without a direct connection between the corporate minimum tax and book income, Congress' goal of eliminating the spectacle of high-income corporations paying little or no tax seems unlikely to be fulfilled. Taxpayer's perceptions of income tax unfairness that are due to reports of corporations reporting substantial book income and paying no tax will continue. The current tax reform effort will fall very short of its potential.

This committee may well wish to reject financial reports of book income as the general corporate minimum tax base because financial reporting, by its nature, is inherently conservative. It is designed to err on the side of understatement rather than overstatement of income so that shareholders and creditors will not be presented with an unduly favorable picture of the corporation's income for the year. This may mean that using book income as a minimum tax base would not sufficiently ensure that all corporations with significant amounts of economic income will pay the corporate minimum tax.

On the other hand, using domestic profits reported for financial reporting purposes as a floor -- an absolute minimum -- in measuring corporate minimum taxable income will not serve to increase corporate opportunities to avoid tax, but should ensure that a corporate minimum tax is able to serve effectively its intended purpose of eliminating this important source of taxpayer perceptions of income tax unfairness.

A book income floor could achieve great benefits in this regard without significant costs in terms of complexity. Corporations must calculate their book income for other purposes and little additional cost should be entailed in using these calculations for corporate minimum tax purposes.

## A Final Point: Minimum Tax Revenues Are Deceptive.

It is often said that a genuinely effective minimum tax will raise no revenue. This is because taxpayers will plan their affairs in order to avoid the minimum tax or in such a way as to be right at the margin between payment of regular tax and payment of minimum tax. But this does not mean that a minimum tax is not producing revenue; it means only that revenue that is raised due to the minimum tax may show up as regular income tax revenue rather than minimum tax revenue. Setting a floor on both the individual and corporate income tax that must be paid on economic income -- whether at 15%, 20% or 25% -- if done in a thoroughgoing way, will mean that all individuals and corporations will pay that minimum amount. The more comprehensive the minimum tax base, the more effective it will be. It is only an accident of accounting that the increase in revenues produced under the regular income tax due to the existence of an effective minimum tax is not attributed to the minimum tax.

Senator MOYNIHAN. I believe, Professor Gutman, you are next.

## STATEMENT OF PROF. HARRY L. GUTMAN, PROFESSOR OF LAW, UNIVERSITY OF PENNSYLVANIA LAW SCHOOL, PHILADELPHIA, PA

Professor GUTMAN. Thank you, Senator.

I would like to focus on the individual minimum tax, Mike having done the corporate minimum tax.

I would like to talk a little bit about the theory of the minimum tax. There has been a lot of argument over whether there ought to be one and what form it ought to take. I don't think any of us ought to be surprised about that because in fact the debate about whether there should be a minimum tax and what form it should take is a microcism of a much more familiar debate that goes on all the time between those people who believe that the tax system ought to be broad-based and essentially neutral in its application those who believe that the system ought to be used to regulate conduct and provide incentives. That's the classic debate in the income tax. The minimum tax debate is the same debate. So I think that it's very easy to see why it is that people argue about the form and structure of the minimum tax. They are having the same debate all over again, but they are using a different vehicle.

It seems to me that the minimum tax can provide an opportunity to cure some of the problems in the regular income tax because it provides an opportunity for opponents in the income tax debate to compromise. On the one hand, a justification for the minimum tax is fairness, and you can sell something on the basis of fairness. That's a politically acceptable way of doing things. It provides an opportunity for people to say, well, I've got to give up my position, my strict position in the income tax, on grounds of fairness.

The second point is that it is often very hard to figure out what's going on in the minimum tax in terms of economic impact. Therefore a proponent of the use of the regular tax system to provide incentives could be willing to compromise in a minimum tax because it's difficult to see and measure what it is that he's giving up. So as a political matter, it seems to me that a minimum tax can provide a very useful vehicle to assure some fairness in the system and also to assure some proper distribution of tax burdens.

The real problem is that having said that the minimum tax can do those kinds of things, the question is what the minimum tax should be. What principles that guide us as to the design of a minimum tax?

There are generally three reasons why one would enact a minimum tax. One is for revenue. One is to deal with perceptions of fairness. And the third is to broaden the income tax base. After you have got the minimum tax base right, then repeal the rest of the code. That is a strategy that has been articulated by some. And it's a very, very interesting strategy. My friend Graetz has written a very good article about that, in fact.

A minimum tax is a way of raising revenue, but as Mike said, the best minimum tax might produce no revenue at all because it is pushing you into the other tax system. Presumably, if you are satisfied with the other tax system, that's OK; that's exactly what you would like it to do.

In addition, a revenue need doesn't tell you anything about how you ought to raise the revenue. That is to say, what should the rates be, what should the exemptions be, what should the base be?

When you move to questions of perception of fairness, you have at least two different issues. There are preferences out there that many people use, like the home mortgage interest deduction. You've seen what happens when you try to deal with the home mortgage interest deduction directly or even indirectly. People don't like it. State and local taxes happen to be another one to the extent that they could be defined as preferences.

It is very difficult to deal with preferences that are widely available. And, indeed, the public reaction to an attempt to deal with them would tell you that people might not care so much about those kinds of preferences. As a result, the kinds of preferences you are drawn to are those that are not generally available.

There is another fairness issue, though, and that's the fairness issue associated with the people who use the preferences to zero out their tax liability. And we have seen plenty of that, starting back in 1968 with Secretary Barr's disclosures and then the annual Treasury reports on high-income taxpayers, and most recently Mr. Pickle's report.

Understanding the latter though, doesn't tell you how to design a minimum tax. It tells you you have got to do something, but it doesn't tell you what the something is.

And, indeed, the only principle approach is to go to a base of economic income. That is the only guiding principle, it seems to me, in the design of an alternative minimum tax.

Now if I could just take a minute to go through a couple of things.

Senator MOYNIHAN. Please do.

Professor GUTMAN. I think we have to recognize that any minimum tax, basically, is born with schizophrenia. It's trying to do a number of different things. The enactment of a minimum tax has the effect of reducing the after-tax value of preferences that exist in the normal tax structure. And so, the congressional objective that gave you the preference in the first place is in some sense being undermined when those preferences become subject to tax in the minimum tax. And so people can say, hey, wait a minute; what are you doing? You are giving it to us with one hand and you are taking it back with the other. That is inherent the minute that you impose a minimum tax and you simply have to deal with that by saying that's the way things are going to be because we have to assure that people are going to pay some tax.

A minimum tax is very difficult to design properly. Bobby has talked a little bit about that, and I think Emil will talk more about it. There are interactions between the regular tax base and the minimum tax base that are very difficult to deal with—net operating loss carryovers and credit carryovers were mentioned. What happens if a deferral item is subject to tax now and then comes into the regular tax base later? How do you make those adjustments? Those are complex problems, and they must be dealt with in a properly designed minimum tax.

Bobby has also talked about the complexity problem. That's a real problem. When the Treasury put out its first proposals in 1984, of course, there wasn't any minimum tax. The reason there was not a minimum tax in Treasury I is because they thought the proposed income tax base was broad enough. With a broad income tax base, you don't need a minimum tax.

When you look at the Treasury analysis of the application of the minimum tax, they said that about 100,000 to 200,000 people had to pay it, but there were perhaps several million who had to plan for it. Those of us who do anything in practice know that there is a new industry out there. It's the minimum tax planning industry. It's a second industry that is laid right on top of the regular tax planning industry. That gives rise to transactions costs that are in some sense unjustifiable. But on the other hand when you impose the minimum tax, it seems to me inevitable that you are going to have those kinds of problems.

When we get to talking about what a minimum tax actually ought to look like, we have to keep those things in mind. There are a number of alternatives to the imposition of an alternative minimum tax which I listed in my statement. As we talk, perhaps it would be worthwhile exploring the present approach in section 291 that cuts down the availability of preferences and applying that on the individual side. There is an issue as to whether the tax should be add on or alternative. And, finally, we could explore whether it's appropriate, instead of an alternative minimum tax, just simply to try and limit the artificial losses that occur with respect to tax shelters.

Senator MOYNIHAN. Professor Gutman, thank you for a superb presentation.

[The prepared written statement of Professor Gutman follows:]

Statement of Harry L. Gutman
Professor of Law, University of Pennsylvania Law School
Before the Senate Committee on Finance
October 9, 1985

Mr. Chairman and Members of the Committee:

I am honored to appear before the Committee today as an invited witness to discuss the issues raised by "minimum taxes" imposed upon individuals.

## Why Impose A Minimum Tax?

A rational minimum tax cannot be designed unless one knows its purpose. Lack of unanimity over the need for and form of a minimum tax stems as much from lack of agreement as to its role in the overall tax structure as from any other single factor. This lack of agreement is not at all surprising. The minimum tax debate is, in large measure, simply a microcosm of the familiar income tax debate in which advocates of a neutral and broad based tax on economic income are pitted against those who would use the tax system to regulate conduct and provide economic subsidies and penalties. If those differences cannot be resolved directly, there is little reason to expect they can be entirely resolved through a surrogate vehicle, such as a minimum tax.

However, a surrogate vehicle may provide a convenient and practical mechanism for compromise between those who hold opposing views of the proper role of the income tax itself. In that sense, a minimum tax may be useful. A minimum tax can be made politically attractive if justified on equity and fairness grounds. Moreover, since the real impact of virtually any minimum tax is difficult to measure, the risk of political accountability is reduced.

While the foregoing may partially explain the current interest in minimum taxes, it does not assist us in designing the structure of a minimum tax. Indeed, to the extent the minimum tax owes its existence to fact that it is a compromise vehicle, we must recognize that we cannot expect much in the way of either logic or consistency. If one is to attempt to analyze minimum tax issues logically, one must start by re-examining the commonly stated reasons to impose a minimum tax and asking the extent to which any of those reasons help us to design the structure of the tax.

There are at least three non-mutually exclusive reasons to impose a minimum tax; revenue, fairness and indirect broadening of the income tax base.

Revenue. A need to raise revenue may lead to a search for alternative sources of tax receipts but, taken by itself, it does not compel one to adopt a minimum tax. Indeed, it could be argued that the most effective minimum tax is one that raises no revenue at all.

Moreover, if revenue is the principal justification for the tax, it does not provide a principle to inform us as to the structure of the tax. Thus, while revenue needs might lead one to consider a minimum tax, more is needed before the structure of such a tax emerges.

**Fairness.** The existence of tax preferences causes different taxpayers with similar economic incomes to pay different amounts of tax. That is a fairness issue. But it is not a fairness issue with political implications if confined to preferences used by a significant number of taxpayers. Reaction to recent proposals to reduce or eliminate the interest deduction for non-business debt illustrate that the public appears not to resent the existence of preferences that are widely used. It is also the case that in most circumstances these types of preferences are not used to eliminate federal income tax liability.

However, the fairness issue has another dimension. Secretary Barr's 1968 disclosures, the Treasury's annual reports on high income taxpayers and Congressman Pickle's recent report confirm that a number of taxpayers with large economic incomes use tax preferences to reduce substantially, or even eliminate, their income tax liabilities. Widespread publicity about these taxpayers breeds resentment among those who have not taken advantage of these preferences despite the opportunity so to do, as well as those who, due to a lack of discretionary income, cannot take advantage of them. Resentment over "abusive" use of tax preferences has at least two consequences. First, there is a loss of respect for the system which manifests itself in various forms non-compliance. The other, which is reinforced by the existence of the first, is pressure on the political process to do "something" about the problem. While it is not clear precisely what the "something" ought to be, it is at least an attempt to assure that all taxpayers pay some tax. Hence, a minimum tax. Indeed, it was precisely pressure of this sort that led to the enactment of the original add-on minimum tax in 1969.

Note, however, that if the sole purpose of the minimum tax is to assure that all taxpayers pay some tax there is no principle that tells us how that should be accomplished apart from the generality that overuse of preferences should be limited. In particular, this justification does not tell us which preferences should be restricted, nor does it tell us whether the minimum tax should be "add-on" or "alternative". Indeed, it is instructive to observe that when the minimum tax was originally enacted in add-on form in 1969, the provision was designed to "make sure that all taxpayers are required to pay significant amounts of tax on their economic income."[1] In 1982, when the add-on minimum tax was replaced completely by the current alternative minimum tax, the amendments had "one overriding objective: no taxpayer with substantial economic income should be able to avoid all tax liability by using exclusions, deductions and credits."[2] Every Committee Report from 1969 through 1982 that explained changes to the form of the minimum tax and its base contains similar language. The point is that while the objective has been articulated, neither its parameters, nor the means of accomplishing it have been completely agreed upon.

Broadening the Income Tax Base. There are many who believe that the income tax should not be used to provide economic incentives. However, there is no question that many of the incentives currently found in the Internal Revenue Code would be difficult, if not impossible, to eliminate directly. Testimony before this Committee on other aspects of the President's Proposals has made this clear. For those who believe, nonetheless, that an attempt to cleanse the Code should be made, a minimum tax provides the vehicle. After an appropriate minimum tax base is established and accepted, the rest of the Code can be repealed. While this process will take time, realistic assessments of the politics of tax legislation could convince one that this is an appropriate tactic to reach the desired long term goal. Indeed, my fellow panelist, Professor Graetz, has explored this aspect of the minimum tax in a provocative article in the Southern California Law Review.[3]

Note that if this is the purpose of the minimum tax, a guiding principle for its design emerges. The tax base should approximate economic income. Moreover, it is more sensible to impose this tax as an alternative rather than add-on tax. This is because an add-on tax, as noted by the Joint Committee Staff in its pamphlet on "Tax Shelters and the Minimum Tax", "functions more like an excise tax on tax preferences...without directly considering economic income as a whole."

## Problems

A minimum tax designed solely to assure that all taxpayers pay some tax is essentially born with schizophrenia. Its enactment has the effect of reducing the after tax value of the preferences that are a part of the minimum tax base to the extent such preferences are utilized by those who become subject to the tax. Thus the Congressional objective that prompted the enactment of the preference in the first place is undermined. Why, ask some, should the value of the preference be reduced just because a taxpayer has done precisely what Congress intended?

Even though the alternative minimum tax base excludes some preferences, the tax may have an impact on the value of those specifically excluded preferences and that impact may appear to some to fall in an arbitrary way. For example, two taxpayers with the same amount of preferences and the same amount of adjusted gross income may find themselves subject to different amounts of minimum tax due simply to the amount of charitable contributions made by each. Conversely, the value of the charitable contribution deduction, which is not an item of tax preference, may be affected by the amount of other preferences each taxpayer has. Both results occur because the charitable deduction may reduce regular taxable income to a point where the alternative minimum tax exceeds the regular tax paid. If the judgment has been made that charitable deductions are not to be preference items, then it is difficult to see why their existence should trigger the imposition of a minimum tax. However, the solution is difficult to design.

Indeed, there are a number of other difficult design problems associated with the alternative minimum tax. These problems relate principally to the interaction between the alternative and regular tax with respect to items that fall within one tax during one year and the other in another. Net operating loss and credit carryovers are two examples. The proper treatment of "deferral" (as compared to exclusion-type) preferences is another.

The imposition of a minimum tax makes measuring the economic impact of the preference much more difficult. We are all aware of the measurement difficulties asociated with attempting to estimate the costs and benefits of tax preferences without a minimum tax. Once a minimum tax is imposed, the rather random nature of its incidence, depending as it does on so many exogenous factors, makes that task appear to a layman to be virtually impossible. Perhaps my fellow panelist and former colleague, Emil Sunley, can straighten me out.

The existing alternative minimum tax is complex. The proposals to expand its scope will add more complexity. This complexity imposes some significant costs on the tax system. First, it has created a whole new tax industry--the minimum tax planner. According to the Treasury, between 100,000 and 200,000 taxpayers pay minimum tax under the current regime. However, Treasury also estimates that perhaps several million taxpayers actually compute their alternative minimum tax liability either to see if they are subject to the tax or to determine the steps to take to avoid its imposition. These transaction costs, together with the corresponding enforcement costs to the Internal Revenue Service, are difficult to justify. Moreover, any practitioner familiar with minimum tax planning will tell you that in many cases the steps that are taken to avoid the minimum tax are, in fact, transitory. Postponing deductible expenses or accelerating discretionary receipts are obvious examples. The timing of capital gains or losses--not unique to the alternative minimum tax--is another. Not only do taxpayers time capital gains and losses to minimize regular tax liability; they now engage in the same activity to control alternative minimum tax liability.

I suppose there are those who would argue that if taxpayers avoid the minimum tax by paying regular tax, the purpose of the provision has been accomplished. It is in this sense that the best minimum tax would be one that raised no revenue. If that occurred it would be because all taxpayers paid an amount equal to their potential minimum tax within the normal tax structure. But the current regime imposes costs that some may view as excessive in light of the resultant benefit.

This catalogue of problems does not mean that an alternative minimum tax should be rejected. It does, however, indicate that care and attention are required to produce a workable system.

## Solutions

As usual there are no easy solutions. If the income tax were not so riddled with preferences there would be no need for a minimum tax. Indeed, the 1984 Treasury Proposals suggested repeal of the alternative minimum tax, not to eliminate the problems outlined above, but rather because the regular income tax base suggested in the proposals was broad enough to eliminate the need for an additional tax. However, if the tax base is not to be broadened sufficiently, some form of minimum tax is necessary to ensure that all citizens bear a fair share of the costs of running the federal government.

Despite the problems noted above, an alternative minimum tax imposed on a broad base of economic income is, in my judgment, the best solution to the problem precisely because the tax bears some relationship to economic income. The alternatives I shall now address have certain comparative advantages, but each has defects, political or otherwise, that on balance lead to their rejection.

One alternative approach is to apply the section 291 solution to individual preferences through a statutory reduction of the maximum allowable amount of the preferences that are thought to cause the most problems. That approach has been suggested by Congressman Stark and Senator Chafee. It explicitly reduces the subsidy element in the listed preferences as compared to the implicit reduction achieved by the alternative minimum tax. Explicit reduction of preferences, while a laudable goal, is likely to be politically stillborn.

If the objective is to assure that some tax is paid on account of excessive use of preferences, a return to the add-on minimum tax without an offset for regular tax paid is a second possible approach. The problem here is in three parts. The first is to define "excessive" use of preferences. The second is to determine which preferences would be included in the base. The third is the fact that the tax is not imposed with regard to economic income, but rather simply on the excessive use of the preferences included in the base. It should be noted that while the form is different, an add-on tax on excessive preferences may not differ in impact, when it applies, from the section 291 approach.

A third alternative, which focuses principally on "tax shelter" losses, is to defer the deductibilty of losses attributable to tax preferences until income from the activity to which they relate is sufficient to offset them. There is precedent for this approach in provisions limiting the deductibilty of non-business interest and the now repealed excess farm loss account provisions. This approach reduces the value of the preference by deferring its use. However, so long as the activity to which the preference relates does in fact generate taxable income (before the preference is taken into account) the preference is not lost. One problem with this approach is that pressure is placed on what items are included in the "basket." A second is that it focuses on "timing" preferences to the exclusion of preferences that permanently exempt economic income from the tax base.

I have not dealt with specific technical issues of the proposed amendments to the existing alternative minimum tax in this statement. However, I am happy to answer questions on those issues as well as any relating to my statement.

FOOTNOTES

[1] General Explanation of the Tax Reform Act of 1969, p. 105.

[2] General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, p. 17.

[3] Graetz, "The 1982 Minimum Tax Amendments as a First Step in the Transition to a 'Flat-Rate' Tax," 56 S. Cal. L. Rev. 527 (1983).

Senator **Moynihan**. Before I turn the Chair over to the chairman, I am compelled to instruct you, as a professor of law, that the deduction of State and local taxes is not a tax preference; it is a constitutional requirement. [Laughter]

Professor **Gutman**. I understand. The example was carefully chosen.

Senator **Moynihan**. Senator Pryor has also joined us, Mr. Chairman. Why don't I just step aside here and let you take over.

The **Chairman**. I apologize for my tardiness. Bob, did you get the note that said I left?

Mr. **Shapiro**. Sure.

The **Chairman**. Mr. Shapiro has been through this before. We are involved in the debt ceiling. That's nothing new. But we are also involved in changing maybe some law involving the budget act and there were some parts in it that were very deleterious to the jurisdiction of this committee and so Senator Long and I were meeting with some others this morning on an issue that is very dear to us. Hopefully, we have been successful.

I had a chance to read your statements last night. I appreciate you getting them in ahead of time. And I don't know how far along you are, Senator Moynihan, in the questions.

Senator **Moynihan**. Mr. Sunley would be next.

Senator Pryor has just arrived and hasn't been able to say anything.

Senator **Pryor**. I don't need to say anything at this moment.

The **Chairman**. Mr. Sunley, go ahead.

## STATEMENT OF EMIL M. SUNLEY, DIRECTOR OF TAX ANALYSIS, DELOITTE, HASKINS & SELLS, WASHINGTON, DC

Mr. **Sunley**. Thank you, Mr. Chairman. I am most pleased to have been invited to appear before this committee today to present my views on the minimum tax.

Minimum taxes blunt the incentive effects of tax preferences. For taxpayers subject to a minimum tax, at the margin, they receive no benefit from various tax incentives.

One may well ask if Congress wants to encourage, say, investment in real estate. Why do we care that Professor Graetz and Professor Gutman each do a little investing in real estate and therefore are not subject to the minimum tax, and I do a lot of investing in real estate and am subject to the minimum tax.

Imposing a minimum tax says that it is all right to do a little investing in real estate but if you do too much, we are going to slap your hand.

Well, the reason why we care is really straightforward. The spectacle of high-income taxpayers zeroing out their tax liabilities undermines the perceived equity of the tax system. And if it becomes widely perceived that for high-income individuals and families the individual income tax is largely a voluntary tax, voluntary compliance will certainly fall off.

Minimum taxes add considerable complexity to the tax law and complicate tax planning. This is particularly true for taxpayers who, 1 year are subject to the minimum tax and the next year are subject to the regular tax.

In spite of the fact that minimum taxes blunt the incentive effects of tax preferences and considerably complicate the tax law, I support a limited minimum tax—particularly, in the context of a general lowering of marginal tax rates. But the tax must be carefully constructed so as to limit unintended effects. This requires making tradeoffs between equity, efficiency, and simplicity.

In shaping a minimum tax, the committee must deal with three fundamental issues. The first is whether the minimum tax should cover both individuals and corporations. I agree with Professor Graetz that the case for applying a minimum tax to corporations is much less compelling than that for applying the minimum tax to individuals. Nevertheless, I assume that any minimum tax that we are talking about will apply to both individuals and corporations.

The second fundamental issue is whether Congress should enact an add-on tax, such as the current minimum tax applying to corporations, or an alternative tax, such as the tax enacted for individuals in 1978. An add-on tax is essentially an excise tax on the excessive use of tax preferences. In contrast, an alternative tax could take into account the taxpayer's total economic income.

The case for an alternative tax is straightforward. Under current law, taxpayers may combine various tax preferences and reduce their tax liability to zero. However, taxpayers cannot reduce their tax liability below zero. But there is nothing magical about zero. Congress could decide that taxpayers should only be permitted to combine tax preferences to reduce their tax liability to, say, 15 or 20 percent of income.

A major drawback to an alternative tax is that it is much more complicated than an add on one. An alternative tax requires running two tax systems in parallel—the regular tax system and the alternative tax system. And it's very important to get the rules right for those taxpayers who, 1 year are subject to the regular tax and the next year are subject to the alternative tax.

For example, if, under the alternative tax, the net operating loss deduction, or NOL, is disallowed, as was proposed by President Reagan in 1982, a tax will be imposed on a corporation which, over a 2- or 3-year period, has no economic income. If the net operating loss is allowed, the NOL should be reduced to the extent that previously allowed tax preferences increase the size of the NOL. That is the current rule for the alternative minimum tax for individuals.

Thus, the NOL for the alternative tax would differ from the NOL from the regular tax, and separate carryback and carryover accounts are required. Under the alternative minimum tax for individuals, there is no coordination between the two NOL accounts. As a result, the same NOL may be used twice—once for the regular tax and once for the minimum tax.

Under an alternative tax, rules are also needed to coordinate the investment tax credit with the minimum tax. Otherwise, the alternative minimum tax can wipe out the investment tax credit. It seems important to me that the rules for the minimum tax should restore the investment credit to the carryover in those situations where the minimum tax wipes out the investment tax credit.

The third fundamental issue relates to whether the minimum tax should apply to tax deferrals, such as accelerated depreciation. Tax deferrals are incentives that affect only the timing of when tax is paid. A minimum tax with a 15-percent rate can take away the full value of a deferral preference. For example, a 15-percent minimum tax applied to accelerated depreciation of real estate will impose a toll charge greater than the value of the deferral benefit if the building is soon sold and the excess depreciation is recaptured at ordinary rates.

This problem can be alleviated with appropriate basis adustment rules, but these rules add complexity. Alternatively, taxpayers could be permitted to elect to forgo tax preference components of various tax preference items so as to avoid the excessive tax on deferral preferences.

Mr. Chairman, I conclude my statement with several comments on specific tax preference. Let me mention only one. The Ways and Means Committee staff option published September 26 would treat as a preference losses attributable to a limited partnership interest. This is not an appropriate rule. To the extent these losses are attributable to the use of preferences, the minimum tax should directly address those preferences and generally does so. Under the staff option, real economic losses would be treated as a preference. Proposing a minimum tax on economic losses is just not a sensible policy.

Thank you.

The CHAIRMAN. Thank you, Mr. Sunley.

[The prepared written statement of Mr. Sunley follows:]

STATEMENT OF

EMIL M. SUNLEY
DELOITTE HASKINS & SELLS

ON

MINIMUM TAX PROPOSALS
BEFORE THE SENATE FINANCE COMMITTEE

October 9, 1985

I am Emil M. Sunley, Director of Tax Analysis in the National Affairs Office of Deloitte Haskins & Sells, an international accounting firm. I am most pleased to have been invited to appear before you today to present my personal views on proposals for a minimum tax.

The minimum tax is everybody's second choice. The original minimum tax for individuals was developed at the Treasury Department at the end of the Johnson Administration as a back door means of increasing the maximum tax rate on capital gains to 35 percent. The Treasury despaired that Congress would ever repeal the 25 percent alternative tax on capital gains. If tax preferences cannot be attacked directly, then getting at them through a minimum tax is better than nothing, or so the argument goes. Today, the winds are blowing in the direction of base broadening. Some would prefer this Committee to substitute a minimum tax for a more direct attack on tax preferences.

Let me say at the outset what' the minimum tax is not. First, it is not a big revenue raiser. The minimum tax raised less than $2 billion from individuals in 1983 and less than $500 million from corporations in 1982, the last years for which data are available. The strengthened minimum taxes proposed by the Administration would increase revenues from individuals by about $300 million a year and from corporations by about $700 million. Enacting the Administration's minimum tax does not make or break the tax program. A minimum tax could be designed that would raise substantially more revenue. But such a tax would be a direct assault on tax incentives such as accelerated depreciation. I believe, the Committee should deal directly with those preferences that apply to all taxpayers.

Second, the minimum tax is not a long-run strategy for tax reform. Some have suggested that a broad-based minimum tax could be the first step in achieving true tax reform. Over time, the alternative tax could replace the regular tax. This would be accomplished by increasing the rate of the alternative tax while lowering the rate of the regular tax until most taxpayers were subject to the alternative tax. Though I suppose this could happen, I would not enact a minimum tax on those grounds.

Minimum taxes should be enacted not to raise large amounts of revenues or as a strategy for long term tax reform. The objective of a minimum tax should be much more limited. A minimum tax can ensure that high income taxpayers, and large profitable corporations pay some minimum rate of tax on their economic income. This objective is achieved at the cost of considerable complexity and a blunting of tax incentives. Any minimum tax blunts the incentive effects of tax preferences. Congress, by enacting a minimum tax, in effect, is saying that if a person engages only a little in activities encouraged by tax subsidies, no minimum tax is imposed. But if the person is good at these activities and specializes in them, he will have to pay the minimum tax, putting him at a competitive disadvantage.

In enacting a minimum tax Congress must deal with tradeoffs among the fundamental goals of simplicity, fairness and efficiency. On balance, I support a limited minimum tax, particularly in the context of a general lowering of marginal tax rates. A minimum tax can ensure that high income individuals and large, profitable corporations pay at least a minimum amount of tax. However, the tax must be carefully designed to minimize unintended effects.

What I believe I can most usefully do for this Committee is to outline the three fundamental issues in designing a minimum tax: (1) Should the tax cover both individuals and corporations? (2) Should the tax be an add-on or an alternative tax? (3) Should the list of preferences include both tax exemptions and tax deferrals?

My statement concludes with some observations on the treatment of net operating losses, the investment tax credit and several of the tax preferences that might be included in the base of a minimum tax.

## THREE FUNDAMENTAL ISSUES

### Individuals versus Corporations

The original minimum tax proposals in 1969 would have applied only to individuals. These proposals recognized that individuals with large economic incomes should pay a fair share of the tax burden. If they do not, the perceived fairness of the tax system is eroded, and tax compliance is undermined.

The case for a minimum tax on corporations is much less persuasive. A corporate minimum tax may result in unintended distortions across firms in the same industry. For example, if mineral depletion is a preference for the minimum tax, a stand-alone copper company may be subject to that tax. But if a similar copper company is owned by a diversified manufacturing corporation, the conglomerate may have sufficient regular tax liability so as to avoid the minimum tax. Imposing a minimum tax on corporations encourages tax induced mergers that serve no useful economic purpose. Moreover, a separate minimum tax on corporations may be seen as basically inconsistent with steps toward integrating a corporate and individual income taxes. It seeks to increase the degree of double taxation rather than to reduce it and the burden may fall on shareholders and customers who in fact pay their fair share of individual income taxes.

## Add-on versus Alternative

A minimum tax can be an add-on tax such as the current minimum tax applying to corporations or it can be an alternative tax such as the tax enacted for individuals in 1978. An add-on tax, even with a deduction for regular taxes, is essentially an excise tax on excessive use of preferences. It reduces the value of those preferences without considering the taxpayer's total economic income.

An alternative minimum tax applies to a taxpayer's regular taxable income plus certain specified tax preferences. An alternative tax could be optional or mandatory. If it is optional, taxpayers would pay the lower of their regular tax or their alternative tax. Senator Russell Long proposed such an alternative tax 20 years ago. If the alternative tax is mandatory, as is the current alternative tax for individuals, taxpayers are required to pay the greater of their regular tax or the alternative tax.

The case for an alternative tax on a broad base is straight forward: Under current law, taxpayers may combine various tax preferences and reduce their tax to zero. However, taxpayers cannot reduce their tax liability below zero--tax preferences generally are not refundable. There is nothing magical, however, about zero. Congress could decide that taxpayers can only combine tax preferences to reduce their effective tax rate to, say, 15 percent.

An alternative minimum tax is more complicated than an add-on tax. An alternative tax requires running two tax systems in parallel--the regular tax system and also the alternative tax system. It is very important to get the rules right for those taxpayers who one year are subject to the regular tax and then the next year are subject to the alternative tax. Should the net operating loss for the regular tax be allowed for the minimum tax? Should the minimum tax wipe out the investment tax credit allowed for the regular tax or should it only delay when the investment tax credit can be used? I return to these issues later.

## Exemptions versus Deferrals

Tax preferences come in two types. They are either tax exemptions such as the exclusion for net long term capital gains, or they are tax deferrals such as accelerated depreciation. Tax exemptions provide a permanent reduction in tax. In contrast, tax deferrals are incentives that affect only the timing of when tax is paid.

The original minimum tax proposed at the end of the Johnson Administration would have applied only to certain exempt items. This would have allowed marginal tax rates up to 35 percent. Once Congress decided to include deferral items, such as accelerated depreciation on real property in excess of straight-line, the rate of the tax had to be moderated unless very complicated basis adjustment rules were to be provided. A minimum tax with a 15 percent rate can take away the full value of a deferral preference. For example, a 15 percent minimum tax applied to accelerated depreciation will impose a "toll charge" greater than the value of the deferral benefit if the building is soon sold and the excess depreciation is recaptured at ordinary rates. This problem would be alleviated with appropriate basis adjustment rules. The judgment in the past has been that the add-on corporate minimum tax rate of 15 percent did not impose a sufficient toll charge to warrant complicated basis rules.

When the alternative minimum tax was first enacted for individuals in 1978, it applied to only preferences which are exclusions or exemptions. Deferral-type preferences continued to be subject to the add-on minimum tax. In 1982

Congress repealed the add-on tax for individuals and included deferral-type preferences under the alternative tax for individuals. The current add-on corporate minimum tax applies to both deferral-type and exemption preferences.

An alternative tax, like the add-on tax, wipes out the full value of deferral preferences for taxpayers subject to the alternative tax one year and the regular tax the next year. For example, under the Administration's proposal, accelerated depreciation on real estate may be taxed under the alternative tax at a 20 percent rate in year 1. In year 2, the taxpayer sells the building and is then subject to full recapture at the 33 percent tax rate. It is contemplated that under the Administration's proposal, taxpayers may elect not to accelerate depreciation.

## SPECIFIC ISSUES

### Net Operating Loss

An alternative minimum tax must be closely coordinated with the regular income tax. If under the alternative tax the net operating loss deduction is disallowed, a tax would be imposed when a corporation over a two or three year period has had no economic income. If an NOL is allowed, certain adjustments are required to take account of the impact of tax preferences in prior years that increased the size of the NOL. Thus, the NOL for the alternative tax will differ from the NOL for the regular tax and separate carryback and carryover accounts are required. Under the alternative minimum tax for individuals there is no coordination between the two NOL accounts. Thus, if a larger NOL is used for the alternative tax than for the regular tax, the amount of the NOL carryover for the regular tax is not reduced. As a result, the same NOL may be used twice. To the extent that a larger NOL is used for the minimum tax than for the regular tax, the regular tax NOL carryover should be adjusted, but not dollar for dollar. The extra NOL used for the minimum tax saved taxes at a lower marginal rate than it would have saved taxes if used for the regular tax. A fractional adjustment would seem to be appropriate. But given progressive tax rates it is unclear just what should be the fractional adjustment. Alternatively, if a dollar for dollar adjustment is required, taxpayers might be permitted to elect not to use their NOL for the minimum tax and save it for the regular tax with its higher marginal rate.

The problems of coordinating an add-on minimum tax with the regular income tax are not as severe as those of coordinating an alternative minimum tax with a regular tax. However, under an add-on minimum tax, a tax benefit rule is needed so preferences are not taxed under the minimum tax when they provide no current tax benefit. Instead the preference would be deferred until it provided a benefit under the regular income tax. The alternative minimum tax for individuals also requires a tax benefit rule because of the interaction of the itemized deduction preferences and the 60 percent exclusion for capital gains. Absent such a rule, taxpayers can get hammered twice.

The concept of a tax benefit rule is fairly simple. Drafting one is very complicated. Treasury has not been able to issue regulations on the tax benefit rule under either the add-on or the alternative minimum taxes.

## Investment Tax Credit

Under the Administration's proposal for an alternative minimum tax for corporations, the investment tax credit will not be allowed against the alternative tax liability. This, in effect, treats the investment tax credit as a preferences for purposes of the alternative tax. The disallowance of the investment tax credit for the alternative tax needs to be coordinated with the regular tax. To the extent the investment tax credit allowed under the regular tax provides no tax benefit, because the alternative tax is higher than the regular tax, the amount of the investment tax credit carryback or carryover should be increased. The current alternative minimum tax for individuals has such a rule. The Administration's proposal is silent on this issue. I urge the committee to follow the rule for individual alternative minimum tax if an alternative tax is enacted for corporations. Even if the corporate minimum tax permits an adjustment to the carryback or carryover, taxpayers with unused investment tax credits will continue to be discriminated against. Other taxpayers will have received the full benefit of the credit when property was placed in service.

## Preferences

If a minimum tax is going to be enacted, the list of preferences subject to the tax should be comprehensive. If significant preferences are omitted, it will still be possible for some taxpayers with large economic incomes to avoid tax. The basic objective of the minimum tax will be undermined.

The Committee may want to distinguish between preferences that generally are available to all taxpayers and preferences that are only available to a few. Making accelerated depreciation on machinery and equipment, for example, a preference under the minimum tax, would sweep most business taxpayers into the net of the minimum tax. The Committee should deal with the general preferences separately. If the Committee does not, every business taxpayer will have to contend with the complexities of the minimum tax whether or not they, in fact, pay that tax.

I am most hesitant to comment on the inclusion of any particular preference in the list of preferences subject to the minimum tax. However, I would like to conclude my statement of comments regarding four preference items.

Under the President's proposal, the untaxed appreciation on property contributed to charity would be considered an item of tax preference. Including this item in the list of tax preferences would have a significant impact on the gifts of appreciated property to universities, museums and other charitable organizations that typically receive large gifts of appreciated property. The reason it will have a significant impact is that taxpayers would wait until the end of their tax year to see if, they are going to be subject to the minimum tax. If they are, they would delay giving appreciated property until a year when they are not subject to the minimum tax. In 1982 when Congress restructured the alternative minimum tax for individuals, Congress allowed the full charitable deduction as an itemized deduction for purposes of the minimum tax. This reversed the decision in 1978 to consider charitable giving a preference. Congress sh~~ould not~~ reverse itself again.

The Administration also proposes as an item of preference 25 percent of the amount by which the taxpayer's interest expense exceeds its taxable interest income, to the extent not in excess of the amount which the taxpayer's CCRS depreciation deductions for personal property exceed those allowable under a system similar to that detailed in the

November 1984 Treasury report. This is a most curious preference item indeed. It either treats excessive interest deductions as a preference or accelerated depreciation as a preference. It would appear Treasury is unclear whether the problem is leverage or accelerated depreciation. I would suggest that leverage is not the problem. And if accelerated depreciation is the problem, it should be dealt with separately, as I indicated above.

The Administration proposes to treat only 8 percent of intangible drilling expenses as an item of tax preference. This 8 percent represents the difference between expensing and the present value of the deductions that would be allowed for CCRS Class 3 property. In contrast, in the case of mine exploration and development costs, the Administration proposes to define the preference as the difference between the allowable deduction and that allowable if costs had been amortized over a ten-year period.

The proposed treatment of intangible drilling expenses represents a departure from the normal rule for other deferral preferences. In effect, the present value rule converts the deferral preference into an equivalent exemption. However, what happens if the property is sold after only one or two years. The taxpayer did not get the full benefit of deferral. Should the minimum tax be recomputed?

I would conclude that all deferral preferences should be treated similarly. The rule for mining exploration and development costs would seem to be the more promising approach.

Finally, there is one last proposed preference item on which I would like to comment. The Ways and Means Committee staff option published on September 26, 1985, would treat as a preference any loss from an investment in which the taxpayer is not a material participant. For example, losses attributable to a limited partnership interest would be a preference item. This is not an appropriate rule. To the extent losses are attributable to the use of preferences, the minimum tax should directly address those preferences and generally does so. If preferences flowing through from a limited partnership are themselves subject to minimum tax, then treating the entire loss as a preference would convert other deductions which the Congress has said are not preferences into preferences. Indeed, real economic losses would be treated as preferences. I would suggest that the combination of at-risk rules, investment interest limitations, and minimum taxes on preferences flowing through to limited participants are more appropriate mechanisms to address the abuses perceived in the limited partnership area. Imposing a minimum tax on economic losses is not sensible policy.

Thank you, Mr. Chairman. I would be happy to respond to any questions the Committee might have.

The **Chairman**. Senator Long, I explained to the panel where you and I were this morning and the very deep interest we had in the particular subject that was being discussed. Do you have any opening statement before we go to questions?

Senator **Long**. None at this moment.

The **Chairman**. Senator Pryor.

Senator **Pryor**. None.

The **Chairman**. Gentlemen, as I read through your statements I think, with one exception, we are in agreement, but let me make sure. The question we get asked all the time by the public, of course, is why don't those rich people and why doesn't General Electric pay taxes. And with very few exceptions of somehow somebody who has cheated, most of them are not paying taxes for reasons of tax policy that Congress has passed. And yet we cannot in our minds allow that to go on. Somehow, no matter what their deductions are, they must pay some tax, setting aside for the moment the issue of interest on State and local bonds as to whether that is constitutional. But setting that aside—I know Senator Long thinks it isn't constitutional. I'm not sure—but the number of people who avoid paying any taxes solely on the basis of municipal bonds is relatively slight anyway.

Is it a fair assumption to start—and I will start with you, Professor Graetz—is it fair to start with the assumption that no matter what your deductions, no matter what your preferences, no matter how legal your adjusted gross income is so that you would owe no tax that you are going to pay some tax?

Professor **Graetz**. Mr. Chairman, it seems to me that the answer must be "yes" if you are going to use the alternative minimum tax as your insurance policy for income tax fairness—so that the spectacle that you mention of high-income individuals and high-income corporations paying little or no tax is really going to be avoided. I know in 1969 when the Congress first passed some minimum tax measures this goal was not achieved. There were 154 people in 1969 with adjusted gross incomes over $200,000 who paid no tax and in 1970 that number had gone down to 103, as I recall it. I don't think that you are going to satisfy the American public anymore simply by reducing that number. I think you now have to pass a minimum tax, an alternative minimum tax, that is genuinely going to ensure that corporations with substantial domestic book income and high-income individuals pay some tax. Many former Commissioners of the Internal Revenue, who know more about this than I, suggest that the way the American public is responding to this fairness problem today is by not complying with their income tax obligations.

In 1969, they wrote letters to the Congress. There were more letters in 1969 in response to Joe Barr's statement than there were on any other issue, including the war in Southeast Asia. Now they are not writing the letters as they were before. It seems that they are not complying with the income tax.

And, it seems to me, that this is really the principal threat to the income tax in the United States today. That is why I have recommended in my statement that you not accept arguments about precise adjustments and that you not accept arguments about particular pockets of economic loss when you design an alternative minimum tax. You should bite some bullets that you are not willing to bite under the regular income tax. If you were willing to bite them under the regular income tax, you would not have to have a minimum tax provision. If you can't swallow them under a minimum tax either, then you are going to have a continuing problem—this year it was AT&T and next year it will be somebody else paying no tax.

The CHAIRMAN. But the answer is basically, yes that we are going to have to have a minimum tax regardless of the exemptions, deductions, credits or whatever else your preferences may be.

Professor GRAETZ. Yes. You are going to have to have a minimum tax, and you are going to have to have a tough one.

The CHAIRMAN. I think I saw Professor Gutman shaking his head when I asked the question.

Professor GUTMAN. Well, I agree with the way you just phrased it, Mr. Chairman. The specific question you asked, I think, was is it necessary that everybody in the tax system pay some tax each year no matter whether he has any economic income or not. And I think the technical answer to that is if you were satisfied that your tax system indeed measured income correctly and somebody had an economic loss, that person should not be paying tax in that year. But that's a pointy headed an academic answer to the question. It almost doesn't make any sense to talk about it in the context of today's income tax because it doesn't come close to measuring economic——

The CHAIRMAN. So as I rephrased the question, you would answer yes also.

Professor GUTMAN. Absolutely, yes.

The CHAIRMAN. Mr. Shapiro.

Mr. SHAPIRO. Yes. I totally agree that every individual and every corporation should pay what is perceived to be their fair share of tax. Going back to the annual basis, it's not necessarily an annual basis because in some cases you've got—particularly in corporations—you've got bad economic years, certain investments they make, so you should have some averaging advice which goes into account some of the carryovers that are being proposed.

But the bottom line is every individual and every corporation should be accountable to pay a fair share of tax on their income.

The CHAIRMAN. Mr. Sunley.

Mr. SUNLEY. Yes. In my statement, I said that the case for an alternative tax is that you could limit taxpayers to sheltering their income down to an effective tax rate of, say, 15 or 20 percent. In contrast, under current law, taxpayers can shelter down to zero. There is nothing magical in saying that taxpayers must stop at zero. You could say that taxpayers have got to stop at 15 percent.

The CHAIRMAN. Senator Long.

Senator LONG. Mr. Shapiro, I would hope that you could stay after your panel has finished testifying. I would like to discuss some parts of your statement with you. I've read it, but I haven't had a chance to do it justice. I would like to ask you more about it than I can ask in the brief time I have here.

I would like your thoughts about one matter now. I'm sure you are aware that there were actually two famous *Pollock* cases. One of them held that the income tax was unconstitutional. That was before whatever the amendment was that started the income tax.

Professor GRAETZ. Sixteenth.

Senator LONG. Sixteenth. One of the *Pollock* cases held that it was unconstitutional to tax individuals in a way that amounted to a direct tax without apportionment. As I recall, the other part held that you could not tax the income on State bonds. I think that went back even prior to that, to *McCulloch* v. *Maryland,* which established the principle of reciprocal immunity and said that the power to tax is the power to destroy.

I hope that we don't have to get involved in trying to tax State and municipal bonds. I hope we can avoid that. When Mr. Simon was Secretary of Treasury, he used to sell those kind of bonds. He expressed his point of view that those bonds had already been taxed by virtue of the fact that by lending money to State governments, the taxpayer gets about 20 percent less income. The bond holder owes taxes, but he has about 20 percent less income. In effect, he has already been taxed 20 percent to benefit the State government. That was Secretary Simon's argument.

However you look at it, I can understand why the States, as well as others are concerned about the overall issue and are very upset at the prospect of our taxing State and municipal bonds. It occurs to me that if you wanted to do something, you might look at the situation where one borrows money. The law already says that if you borrow money to buy State and municipal bonds, you can't deduct the interest expense on the money you borrowed. Isn't that right?

Professor GRAETZ. That's correct.

Senator LONG. All right.

Professor GRAETZ. For individuals only. That rule does not apply to corporations today.

Senator LONG. Individuals?

Professor GRAETZ. Banks can borrow and deduct interest.

Senator LONG. If you wanted to, you could tighten up on that by saying that it applies to all corporations as well. You also could say, for purposes of a mimimum tax, that to the extent you have interest expense from any source, you could not deduct that interest expense to the extent that you have tax-exempt interest from bonds. You could say that if you wanted to. And I think that you would be on a sounder basis there than you would be by saying that you are going to tax State and local bond interest directly.

What is your thought about that subject? What might be the better approach to try to obtain some revenue and meet a minimum tax purpose that you described here?

Mr. SHAPIRO. You want me to start off with that, Senator Long?

Senator LONG. Yes.

Mr. SHAPIRO. I think one of the points that I and most of us made on the panel is that you should not necessarily view a minimum tax as a revenue raiser. The minimum tax should be viewed as a means to provide the credibility for the system that all individuals would pay what should be perceived as a fair share and should not be able to stack up or use any particular preference to an excessive amount, to not pay a fair share or pay too low a level of tax.

As a result of that, it means you've got to look at a lot of aspects of the tax, the minimum tax, which is the rate, the exemption, the preference items, as to how to put that together. When you look at one particular item, such as tax-exempt bonds, the constitutional issue is a very interesting one. There are strong views on each side, and the Congress has focused on that. In 1969, the Ways and Means Committee in their bill dealt with taxes and bonds. It was not pursued in the Senate. It was dropped in conference.

When you are dealing with the interaction of the interest, what is referred to as the section 265 provision on individuals, which disallows the deduction by an individual of interest to the extent they borrow money to purchase tax-exempt bond that has to be taken into account in the context that that affects State and local bonds and what is the policy with regard to having an adverse effect on banks or financial institutions or others to buy certain bonds where that is a day-to-day practice with regard to business, corporations as opposed to individuals.

That gets to another point that is very complicated that several of the panel members have also addressed. And that is there may be a very strong argument that I think all of us agree that an individual—that a minimum tax is appropriate in the case of individuals. They have more or less an annual accounting, and as a result of that, a minimum tax focused on them is clearly appropriate.

In the cases of businesses, corporations, there can be an argument that because of business cycles, the fact that they can merge and get a high effective rate corporation merging with a low effect rate to neutralize the effects of minimum taxes, the fact that they may make investments in areas that have preferences one year but in the next year they are paying more taxes, so how do you look at them through business cycles. That the concept of a minimum tax on corporations is not the same as it is with individuals. That doesn't mean you don't have it, but you have to focus on it differently. And, therefore, when you look at the borrowing of money from business sides or financial institutions, do you look at it in the same respect as you impose that provision with regard to individuals that borrow money to invest in tax-exempt bonds?

So I think in that respect one of the aspects is to cut back possibly and to say that if you wanted to say that to some extent borrowed funds cannot be used to invest in tax-exempt bonds, that is being done in the case of individuals, it is not in corporations; should you provide that prohibition in the case of corporations across the board; should you subject it to the minimum tax so you only do a piece of it or do you have some cut back and give some percentage cut back? And those have to be taken in the context of an overall review of a policy of a minimum tax, the policy of investing in tax-exempt bonds and the interaction of interest with respect to borrowed funds that may be made in order to invest in those bonds.

Senator LONG. You don't have a recommendation as to how you would do it if you were going to do it? You explained the things you ought to consider. Would you suggest how to do it?

Mr. SHAPIRO. I have a problem on any particular preference at this point, Senator, in making a recommendation in this sense. The first thing you have to look at is the substantive provision itself. I mean when you have tax reform, look at each one of the areas as to how you want to treat it.

In 1969, as you will recall, the Congress, both the Ways and Means Committee and the Finance Committee, in a major tax reform effort looked at all preferences. Some were repealed because they were no longer necessary. Some were cut back because they were excessive. And to the extent the rest of them were retained in any form, then the Congress looked at a minimum tax as a backstop as a means to make sure that all taxpayers paid their fair share after the Congress looked at the preference items to see how they wanted to deal with it.

And I think at this time you are undertaking a major tax reform effort in looking at the tax system as to how it should be shaped and fashioned with respect to individuals and businesses. After that exercise is finished, then I think it is appropriate to come to a minimum tax to see how the minimum tax backstops the regular system when you finish your tax reform effort. It has clearly taken into account the rate. For example, a comment I made before you and Senator Packwood came in was that when you had a rate in 1969 of 70 percent for individuals and 46 percent for corporations, a minimum tax rate of 10 percent had different effects than when you have a rate that is coming down to a maximum of 35 percent for individuals and 33, 35 percent for businesses and the minimum tax rate going up to 25 percent. You narrow that difference and it has a different impact of a minimum tax.

And as Mike Graetz and others have indicated, a major focus of a minimum tax consideration, which is very important, is not just who pays the minimum tax and what the revenue consequences are of it, but that it acts as a floor for the regular tax because many individuals and businesses who may not pay the minimum tax don't pay it because they are right above it and are paying the regular tax. And they have done some of their transactions and tax planning to make sure that they are right above the minimum tax. So they are affected by it. They don't pay it. They don't pay it only because they have done other things and they are planning to make sure they pay the regular tax.

So you have to focus on all other aspects of the tax system, meaning the regular tax, before, in my judgment, you make your firm decisions on how you interact that with the minimum tax.

Professor GRAETZ. Senator Long, could I just make two brief comments.

Senator LONG. Certainly.

Professor GRAETZ. First is that you are the only member of the committee that was here in 1969, and you probably remember Mrs. Dodge who had $1 million of tax-exempt income and paid no taxes that year. She died since then so I think she is not a problem for the income tax system anymore.

Professor GUTMAN. Gave it all to charities and didn't pay any estate tax either.

Professor GRAETZ. But she would be a problem if she were still alive. And that problem will remain as long as tax-exempt interest is not in the minimum tax base. The Senate in 1982 would have included tax-exempt interest in the minimum tax and the House in 1969 would have done it.

About the problem of borrowing, the only comment I want to make is that it is a problem for individuals that goes well beyond borrowing for tax-exempt interest. It involves borrowing for all sorts of tax-favored investments. And the committee should consider extending those limitations on borrowing more generally for individuals than to the tax-exempt interest case. It might also give it thought with respect to corporations.

Professor GUTMAN. Senator Long, could I also make a comment?

Senator LONG. Yes.

Professor GUTMAN. The question that you raised in the specific area of tax-exempt financing is really in another sense a more general question. It points out something that seems to me has to be addressed, and is very difficult in this whole minimum tax debate.

The reason, apart from constitutional questions, that we have the exemption for municipal obligations is to lower the cost of borrowing for municipalities. And, indeed, that is the case, although at least the studies that were produced when I was in the Treasury—and Emil could speak more to this—show it is a fairly inefficient way of doing it.

But, nonetheless, the cost to municipalities is reduced because of the exemption. If you were to eliminate the exemption, you are not going to let the cities, I assume, or municipalities just sit there with increased cost of borrowing. You would be compelled, or at least urged, to take some action to compensate for the denial of the existing preference, which means spending. The taxable bond option, of course, has been mooted many times before this committee. In 1978 Senator Danforth had a proposal like that that was reported out of the committee and subsequently withdrawn on the floor.

The point is that when you have got preferences that are in the code and then you start taking them back, either directly or indirectly, you are affecting Government spending with respect to these items and you are going to get claims on the direct spending side that you have to compensate for that.

Senator LONG. Are you suggesting that we appropriate money to subsidize the State municipal bonds? The problem is that, after a while, the money is gone. It is like revenue sharing. I guess you saw what happened to that. It's gone.

Professor GUTMAN. Exactly. That's what makes it so difficult practically to deal with the issue. If you are going to take away a financial benefit to the municipalities and not replace it, obviously, it's going to be very difficult to do.

Senator LONG. Could I make just one statement, Mr. Chairman.

The CHAIRMAN. Yes.

Senator LONG. When we had that matter before the committee about taxing Mrs. Dodge, it came to an end in the Finance Committee when Carl Curtis, who was the ranking Republican, said he was not willing to put this whole country through the wringer just to tax Mrs. Dodge. The whole thing, you might say, came down to the fact that if we had to go after 50 States and every school district in America in order to tax Mrs. Dodge, it was just not worth it. We forgot about Mrs. Dodge, because it wasn't worth the price we would have had to pay.

I hope that we can meet the problem. I hope that if we have another Mrs. Dodge out there that there is some way we can show proper consideration to all those affected and concerned at the same time that ensure that the new Mrs. Dodge pays something.

I don't have the answers. I'm seeking the answers from you. I'm seeking an answer we can sell to the States.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. I would like to address an issue Mr. Sunley mentioned which is included in the Ways and Means option and the President's alternative minimum tax proposals. I would like to have a more detailed comment from all of you, including Mr. Sunley. I'd like to know what your reaction is to the President's proposal as opposed to the Ways and Means options?

Mr. SUNLEY. I did single out the one preference I thought gave the most trouble; namely, any loss of a limited partnership being treated as a preference. This strikes me as highly inappropriate.

When you get to the President's plan, there is a very obscure preference item there on excess depreciation or excess interest, whichever is greater. It wasn't clear to me whether the Treasury thinks the problem is too much depreciation deductions or too much interest deductions. We have a fundamental problem in our tax system that, in fact, Senator Long was alluding to. To what extent do we worry that someone leverages themself to buy tax-preferred assets. The approach in the President's plan probably is also not workable.

Both the President's plan and the Ways and Means alternative, as you know, include an alternative minimum tax. The President's plan is not fully flushed out. It does not explain what you would do about an investment tax credit which was allowed for the regular tax but was, in effect, wiped out because the minimum tax liability exceeded the regular tax.

Now in the Ways and Means Committee option, you would restore the investment credit to either the carryback or the carryover, which seems to me to be the appropriate treatment.

The Ways and Means option also includes a minimum tax credit which you could apply against your regular tax in a future year. This is kind of an averaging device. To the extent your minimum tax liability in 1 year exceeded your regular tax, that excess would be a credit which you could carry forward to a future year and use it as an offset against your regular tax if in that future year your regular tax exceeded your minimum tax. That gives you kind of an averaging. It works in most situations to achieve the results you are after. I think you can probably find some situations where it doesn't achieve quite the right result.

Senator GRASSLEY. Professor Graetz.

Professor GRAETZ. Yes, Senator Grassley. The options for the minimum tax are quite complicated. I want to limit myself to two or three of the more important aspects of this. The reason I think—although it looks silly for the reasons that Mr. Sunley has suggested—that losses from limited partnerships are suggested as a tax preference for individuals is that there is the widespread belief that a large, limited partnership is more like a corporation than it is like a small, general partnership. This implies that losses to an entity of that sort should not be allowed as deductions on the individual return.

I think that at some point, either on the House or on the Senate side, Congress is going to have to come to grips with the problem of limited partnerships. Limited partnerships have been the major vehicle in the United States for tax shelters for the last several years. And my preference, to use a bad pun would be to say that a large, limited partnership will be treated as a corporation for tax purposes, insofar as limited partners are concerned, and not be able to pass through losses to the limited partners.

That is a controversial proposal. It would create many problems, particularly in the real estate industry and the natural resource area. But that seems to be the reason for the proposal.

I think the reason for that proposal is not as foolish as the proposal may look. The only other thing I would say now is that Chairman Rostenkowski's minimum tax proposal would increase the rate of the minimum tax on corporations to 25 percent from the 20 percent that has been recommended by the President. I think that would be a big mistake.

This may seem odd, given the fact that I have clearly taken the strongest position of this group favoring the minimum tax. But I think that you are much better off with a lower rate, broader based corporate minimum tax that could get every corporation to pay some tax and for minimum tax purposes, don't worry about niceties in the same way you do under the regular income tax. Let them pay minimum tax. Give them extended net operating loss carryovers. If they have real economic losses, sooner or later, they will not have to pay. If they do not want to use a deferral provision for minimum tax purposes, give corporations an election not to use it for the regular tax or to use economic income calculations under the minimum tax.

But I would go for a broad-based, simple minimum tax. And I think a 25-percent rate is both too high in its own right and too high relative to the kinds of corporate rates and individual rates we are now talking about at the top. I do not think that raising the rate to 25 percent would be a wise move at all.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. Thank you, Mr. Chairman.

I just want to observe for the record that it was either yesterday afternoon or last night—I'm mixed up on time. I got home at 4 this morning, so I'm not quite sure what day this is—but by a vote of 88 to 11, the Senate sent to the Finance Committee, I guess you would call it, an instruction to come forward with a minimum tax——

The CHAIRMAN. Corporate.

Senator PRYOR. Corporate minimum tax. And so here we are, and I think we have until May. And I think that's a reaction out there. Any time you get 88 votes for anything these days in the Senate, that says an awful lot about an issue out there in our great land. And I think that the failure of the minimum tax, corporate and individual minimum tax, failure of our present law appears to me the real thrust and the real machine that is driving this so-called thrust for tax reform in the country.

I told my colleagues the other day that in August, I had five town meetings. And I sent out postcards to everybody, and I said, OK, let's meet and talk about tax reform, the President's tax reform. Kind of analyzing those crowds that came to those five regional meetings across Arkansas, I think about one-third of the people came to those meetings because they didn't have anything else to do and it was entertainment, and, second, about a third of them came because they were really concerned and they wanted to express an opinion or see how this was going to affect their tax, the individual tax or the company's taxes. And about the other third of them came because they were mad. They were downright angry. And they were angry at us. They were angry at us. They were angry because we say, well, Mrs. Dodge is no longer alive and that is no longer a problem. But there are a lot of Mrs. Dodges out there today. And people are very angry about this issue.

And I think this committee, and even though we say, yes, we are going to do something about minimum tax, corporations and individuals—but writing that law is not easy. And I think we have just seen some of the complexities of it today.

And I just want to express that that issue out there when it comes to tax reform, I think, is what, at least in our State, is on their minds. They want to see individuals in the higher income tax brackets and corporations pretty well shoulder their fair share. And I think that's what it is.

But I see a total failure right now with the present law. And I just wanted to comment that yesterday that vote of 88 votes was pretty considerably a mandate, as I consider it. I think it was a mandate. I think we are going to be under the gun at that time to come out with something that is fair and is equitable.

So I don't have any more questions at this point. I look forward to further discussion.

The **Chairman**. Senator Bentsen.

Senator **Bentsen**. I've been pouring this coffee straight in my arm at night sessions.

One of my concerns in this is the situation where you have a limited partner, where you are not active in the partnership, limited partnership capacity. And you have a real loss. I don't understand why you shouldn't get credit for that charged against your profits, and why you should still be subject to a minimum tax. And I see that provision in one of these.

That doesn't seem to me to be equity. Do you want to comment on that, Professor?

Professor **Graetz**. Senator, I think the reason for that is the view that when you have a large, limited partnership that it's really more like a corporation than a partnership. If a corporation that you have stock in suffers a loss, you are not entitled to take the loss on your individual return. That corporation has to keep that loss in its accounts to carry that loss forward to be used against its income in later years.

Senator **Bentsen**. You are just classifying. Think of it as a corporation.

Professor **Graetz**. I'm not sure which limited partnerships are more like partnerships and which ones are more like corporations. I agree with you that when you are talking about real economic losses, and not losses from preferences, and about small limited partnerships that look more like proprietorships and more like general partnerships than publicly traded limited partnerships, I think the problem may be different.

I think the problem is really one of people selecting the partnership form when they can use losses and the corporate form when they have gains. There is simply too much flexibility in the form of entity that can be selected for the tax system to be operating properly. I think that's the reason for that proposal. I'm not happy with it.

Senator **Bentsen**. I think my concern for the—what I would think of as a lack of equity in it would have me voting against that kind of a provision.

Let me ask you about another one. And that's your approach to a line of business, classification. I totally agree we need a minimum tax. I think that's absolutely important to restore credibility in the tax system. You have a fellow that can always make $25,000 and he finds he has to pay $1,500 in taxes and he looks up there and he sees a major corporation paying nothing and he says something is wrong with the system.

But I look at General Electric, for example, which does not report for tax purposes, as I understand it, on a line item on line of business method. Why to restore credibility to the system do you have to put line of business in? Why would you suggest?

Professor **Graetz**. Well, I would make two comments. One is that I noted—I think before you came in—that there were two parts of my corporate minimum tax proposal that I considered very important. The first was that book income should serve as a floor for the corporate minimum tax, because I have a feeling that if you do not go in that direction——

Senator **Bentsen**. Book income?

Professor **Graetz**. A corporation's income reported to shareholders for book purposes should be its minimum tax floor—because if you don't go in that direction, then you are still going to have a lot of corporations who pay no tax relative to book income, and that is the way the problem is always reported to the people. The people are going to be as mad with you after the enactment of a minimum tax as they are today. You are not going to solve your basic problem.

If you go down that route—because I think that's more fundamental than the line of business point—if you go down that route, I am less concerned about the line of business point. But my point in that connection is that even though in the regular income tax you allow General Electric and other companies to consolidate their income from their main business with their leasing subsidiaries, that such consolidation may not be appropriate under a minimum tax designed to address this problem. It is the General Electrics that are the problem. And you do not want to encourage further mergers because of a minimum tax provision that would say we are now going to have a tax if the only way to get around it is to create more subsidiaries or to have more mergers.

One of the complaints that is often advanced about a corporate minimum tax that—unlike an individual, corporations can create babies without a 9 months' delay. And so one of the things that is always argued about a corporate minimum tax is corporations are just going to merge and create more loss subsidiaries and so forth to avoid the tax.

The line of business suggestion that I made is really just a suggestion. Think about that problem seriously and see if there is not some way to limit the ability of corporations to use these unrelated losses—losses unrelated to their main line of business—to avoid paying any tax altogether. Otherwise, I don't think you are going to solve the basic political problem, the basic perception that the worker person in America has of these large corporations not paying any tax. And you don't want to keep doing this year after year. I think that's the main thrust of that suggestion. I'm tentative about it. It may be a radical idea, but it seems to me we may have a radical problem.

Senator **BENTSEN**. You are a very candid fellow.

The **CHAIRMAN**. Any other questions, gentlemen?

[No response.]

The **CHAIRMAN**. Folks, if not, thank you very much.

And we conclude this morning with Mr. Raymond Donohue. Go right ahead, Mr. Donohue.

## STATEMENT OF RAYMOND J. DONOHUE, VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, MATSON NAVIGATION CO., INC., SAN FRANCISCO, CA, ACCOMPANIED BY THOMAS L. MILLS, ESQUIRE, KOMINERS, FORT, SCHLEFER & BOYER, WASHINGTON, DC

Mr. **DONOHUE**. Thank you, Mr. Chairman, and other members of the committee.

I'm testifying today on behalf of Matson Navigation Co., Crowley Maritime Corp., and the Council of American-Flag Ship Operators.

My testimony is also supported by the Shipbuilders Council of America and fishing industry groups.

I'm accompanied by my counsel, Mr. Thomas Mills.

The President's tax proposal seeks to repeal the Capital Construction Fund Program. We strongly oppose this proposed repeal. Basically, the CCF works like an IRA for the U.S. maritime industry. Taxes are deferred on deposits into the fund, and then subsequently repaid when funds are withdrawn for construction of qualified vessels in U.S. shipyards.

The repeal of CCF would have extremely adverse effects on our companies. However, the arguments against repeal go much further than simply this financial impact. Our reasons against repeal are, first, the CCF is a maritime program authorized under the Merchant Marine Act. It is not part of the Internal Revenue Code, and is not administered by the Treasury Department. It should not, then, be repealed in isolation from the National Defense, Maritime, and Fisheries' objectives that it was intended to achieve.

Second, repeal of the CCF will provide minimal additional revenue. The Treasury Department and the Joint Tax Committee estimate that the repeal would generate about $400 million over the next 5 years. This relatively small figure is even double the cost that we estimate. The Treasury figures are based on the view that the CCF is a tax exemption program. It's not that at all. It's a tax-deferral mechanism. Treasury's calculations give no effect to the fact that all of these deferred taxes are repaid to the Government in future years and that the CCF Program, in addition, stimulates more revenues from shipyard employment and the manufactured products used in ship construction.

Our third reason is that American shipyards depend heavily on the CCF Program. Virtually all present commercial shipyard construction work involves CCF financing. Over the past 10 years, CCF programs have financed vessel construction projects at shipyards in Maine, in Pennsylvania, Louisiana, Texas, and Oregon. The value of this construction alone at Bath, ME has been $210 million. At Sun Ship, now Penn Ship, near Philadelphia, $75 million. Northwest Marine and FMC in Oregon, $57 million. Avondale and McDermott in Louisiana, $370 million recently. Bay Shipbuilding in Wisconsin now has a project totaling $191 million, and next year Matson Lines plans a construction project for $35 million.

All of these projects and many others were and are being financed with CCF moneys. And this isn't all. The American fishing industry has built more than 3,200 fishing vessels under the CCF Program. Many small coastal shipyards are involved in these projects, including 16 shipyards in Texas and several in Rhode Island.

Briefly, there are four other critical reasons why we think that CCF repeal is a bad idea.

The first one is that our noncontiguous areas of Hawaii, Puerto Rico, and Alaska depend primarily on waterborne transportation. Without CCF funds, vessels will become more expensive to build. Higher transportation costs leads to higher consumer costs. This will encourage reliance on cheaper foreign products carried into these areas on foreign vessels; and this could affect the cargo levels now moving off the Pacific coast to Hawaii and even Alaska.

National defense requirements is our second point. Sea lift capacity would be severely undermined by repeal, and this is recognized by the Department of the Navy.

The third point is that CCF's are enforceable contracts and that the proposed repeal, we think, would be a taking under the Constitution—an unconstitutional taking.

Our final point is that repeal of the CCF would create tax policy discrimination which would favor foreign steamship companies who compete with U.S. flag companies and now have available to them the subpart F exemptions.

In summary, we realize that the CCF is a very small issue in terms of overall tax policy, but it's vital to our companies, and we think vital to the American flag Merchant Marine and fishing industries.

Thank you.

The CHAIRMAN. Thank you, Mr. Donohue.

In addition to your counsel, I see you have Peter Friedman with you for whom I have the highest regard and I'm glad that he's with you.

Mr. DONOHUE. Thank you. He's always a good backup.

[The prepared written statement of Mr. Donohue follows:]

## Summary Statement of Raymond J. Donohue,
## Matson Navigation Company, Inc.

### Capital Construction Fund

The U.S. merchant marine, shipyards and fishing industry oppose the proposal to repeal the Capital Construction Fund (CCF) program.

CCF program was enacted as part of the Merchant Marine Act, 1936. It is not found in the Internal Revenue Code. It should not be repealed in isolation from consideration of the defense, maritime and fisheries objectives it was designed to achieve.

CCF financing is involved in virtually all commercial shipyard construction work in this country. It has made possible the modernization and expansion of the U.S. fishing industry, and is keeping many small coastal shipyards alive.

Repeal of CCF and the consequent abrogation of these contracts would constitute a "taking" under the 5th Amendment of the Constitution.

Repeal of the CCF program would result in reduced capital for investment in vessels, increased transportation costs to Hawaii, Alaska, and Puerto Rico, and, as a result, upward pressure on consumer costs.

The U.S. merchant marine, which would be seriously hurt by repeal of CCF, is recognized by the Defense Department and Congress as essential to the national security.

The CCF program provides a measure of tax parity with competing foreign shipping lines.

Repeal of the CCF program would provide minimal revenue benefits. Repeal would produce significant revenue losses which must be considered in determining the net revenue impact.

October 4, 1985

## STATEMENT OF RAYMOND J. DONOHUE

Mr. Chairman and members of the Committee on Finance: as Vice President and Chief Financial Officer of Matson Navigation Company, Inc. ("Matson") I appreciate the opportunity to testify concerning the Capital Construction Fund provisions of the President's tax reform proposal. In addition to Matson, I am testifying in behalf of Crowley Maritime Corporation, and the Council of American-Flag Ship Operators. The Shipbuilders Council of America and various fishing industry groups support my testimony today. I ask that their statements be filed separately in the record.

The reason I am testifying is to describe the importance of the CCF program, and the very significant adverse effect the President's proposal to terminate it would have on the American-flag merchant marine fleet, U.S. shipyards and the fishing industry.

Specifically, Chapter 12.04 of the President's tax proposal would repeal the CCF program which is authorized under section 607 of the Merchant Marine Act, 1936. We strongly oppose such a repeal.

The major points I would like to make today are:

### (1) CCF is an Essential Element of National Maritime Policy

The CCF program was enacted as part of an overall Maritime program designed expressly to meet national defense, maritime and fisheries objectives. CCF provisions are found in the Merchant

Marine Act, 1936; they are unique among those provisions addressed in the President's proposal, in that they are not part of the Internal Revenue Code.

The CCF program was originally established by legislation reported by another Senate Committee. In fact, this is the first occasion in which the CCF program has been substantively addressed by this, the Senate tax writing committee. With the recent termination of other Federal shipbuilding subsidies, the CCF program has assumed the most critical role in providing sealift and shipyard capabilities. It should not be repealed in isolation from consideration of overall defense and maritime policies.

### (2) Shipyards Depend Upon the CCF Program

The CCF program is presently involved for virtually all commercial shipyard construction work. Currently, five (5) major commercial ships are under construction in U.S. shipyards. All are using funds accumulated in CCFs. It is questionable whether all of these ships would be under construction today without the CCF provisions now under attack. Elimination of the CCF program would have a devastating impact on what is left of our domestic shipbuilding industry.

Specific projects undertaken with the use of CCF moneys by Matson and other companies in shipyards in Pennsylvania, Oregon, Louisiana, Maine, Texas, and elsewhere, illustrate the substantial economic benefits of the capital construction fund program.

Presently Crowley is constructing ocean-going barges at FMC Corporation in Portland, Oregon. This $36 million project is funded using CCF moneys. Similarly, in 1978, Bath Ironworks in Maine built the 26,000 ton containership MAUI for Matson at a total cost of $57 million; and, in 1980, Sun Ship in Chester, Pennsylvania delivered to Matson the $75 million containership KAUAI. These two vessels will be fully paid for by CCF withdrawals. Avondale Shipyard in Louisiana has recently built three containerships for American President Lines at a cost of about $91 million per ship. Also in Louisiana, McDermott shipyard has built 30 vessels, financed through CCF withdrawals, for Crowley at a cost of almost $100 million. Sea-Land, at a cost of $180 million, is building three ships in Sturgeon Bay, Wisconsin to serve Alaska. These are to be paid for by CCF withdrawals as well.

Matson has scheduled for next year a major conversion of the MATSONIA. This $35 million project also will be paid for entirely with CCF money. Proposals are now being considered from shipyards in Alabama, California, Florida and Maryland.

These vessel construction projects have and will accrue thousands of jobs in the states where the shipyards are located and throughout the economy. The CCF program has been critical to the economics of those projects.

### (3) CCF is Important to the Fishing Industry and Shipyards

Thus far I have described some of the major CCF financed projects administered by the Maritime Administration. In addition, the CCF program has made possible the modernization and expansion of the U.S. fishing industry, and is keeping many small coastal shipyards alive.

Presently there are over 1,700 active fisheries CCFs administered by the National Marine Fisheries Service to assist fishermen accumulate capital for vessel construction or reconstruction. The program is effective; over 3,200 fishing vessels have been built using CCF moneys.

Numerous small shipyards from New England to the Gulf, and along the West Coast, are dependent upon fishing vessel work. For example, Texas fishermen have built or are building over 250 vessels using CCFs, and have plans for at least 75 more. Sixteen Texas shipyards are presently engaged in building fishing vessels funded through CCFs.

In Rhode Island, 38 ships have been built or rebuilt under the CCF program, with 15 more on the drawing board. One Rhode Island shipyard, Newport Offshore, is building CCF-funded fishing vessels, while two others are engaged in CCF reconstruction and repair work.

### (4) Repeal of the CCF Program Raises Substantial Constitutional Issues.

By statute a company establishes its CCF through a mutually enforceable contract with the Federal government. The contracts involve specific eligibility standards, mutual commitments, restrictions and significant penalties for unqualified withdrawals. Controlling court decisions suggest that repeal of CCF and the consequent abrogation of these contracts would constitute a "taking" under the 5th Amendment.

### (5) Increased Costs for Consumers in Hawaii, Alaska and Puerto Rico

Repeal of the CCF program would result in increased transportation costs to Hawaii, Alaska, and Puerto Rico. Without the CCF program it would be extremely difficult for American steamship companies to accumulate the substantial amounts of capital (as much as $100 million per ship) necessary to build and maintain modern, efficient fleets. In combination with other elements of the current tax reform proposal, for example, elimination of investment tax credit and the Accelerated Cost Recovery System, repeal of the CCF program would have a serious financial impact on American-flag domestic steamship companies. Fewer capital investments would result in the decline of waterborne transportation systems essential to the economies of the noncontiguous states and territories.

All of the ships owned by Matson and Crowley's barges serving Hawaii, Crowley's fleet (and Sea-Land's planned fleet) for Alaska, and Crowley's fleet serving Puerto Rico, were or will be financed with CCF moneys. The CCF program is of critical importance to the financing of the fleets serving these trades today. Without these modern vessels financed by the CCF program, American-flag companies would be forced to rely on older, less efficient vessels. This, in turn, would put upward pressure on domestic freight rates to Hawaii, Alaska and Puerto Rico, and encourage these economies to rely more heavily on foreign sources of consumer goods carried on foreign-flag vessels.

### (6) CCF Plays an Important Role in National Defense

Although mentioned earlier, the national defense implications must be underscored. The U.S. merchant marine, which would be seriously hurt by repeal of CCF, is recognized by the Defense Department and Congress as essential to the national security. In time of conflict, the U.S. merchant marine, built with the assistance of the CCF program, will be needed to provide critical supply and support services.

The vital national defense role performed by the domestic trade fleet is described succinctly in a paper entitled "Retention of the CCF Program is Vital to the National Defense" which I submit with my statement. Included you will find recent strong expressions from the Department of the Navy supporting continuance of the CCF program.

Moreover, Congress recently established a Commission on Merchant Marine and Defense, which will evaluate the CCF program in the overall context of merchant marine and national defense policy. Abolition of CCF would foreclose the Commission from evaluating and recommending changes and improvements to a program which has been an integral element of national defense policy for many years.

### (7) Repeal of the CCF Program Would Result in Tax Policy Inequities

Currently the CCF program provides a measure of tax parity with competing foreign shipping lines in two respects.

First, vessels built in the United States with the assistance of the CCF program compete with vessels built in foreign shipyards, including those constructed by companies using the "Subpart F exception" in the Internal Revenue Code. Under Subpart F, earnings from foreign vessels owned by U.S.-controlled foreign corporations are exempt from U.S. tax when they are reinvested in foreign vessels and their operation. Repeal of the CCF program and retention of the Subpart F exception would destroy such "tax parity" as now exists between U.S.-built and foreign-built vessels.

Second, virtually every nation with a viable merchant fleet effectively shields its owners from immediate taxation on current income by one means or another. As a practical matter, shipping operations -- be they Greek, British, Norwegian, Japanese, Danish, German or open registry -- have tax parity with their competitors.

Attempts to provide the same tax parity to U.S.-flag operations are included in a variety of provisions. Such provisions include the CCF program, accelerated depreciation and investment tax credits.

The Treasury proposals regarding CCF (as well as decelerated depreciation and investment tax credits) fail to recognize that repeal would create a substantial competitive disadvantage. Foreign competitors could continue to modernize and rebuild their fleets with tax deferred income, while earnings from U.S.-flag operations would be subject to current taxation. The resulting sharp reductions in cash flows, would, in many cases, cause an inability to amortize loans on existing vessels.

We do not want a tax policy which encourages American operators in the international trades to abandon the U.S. flag, and reflag foreign under a foreign corporation.

(8) Minimal Revenue Benefits

Repeal of the CCF program would provide minimal revenue benefits. The Treasury Department has estimated that the CCF program will cost $400 million over the next five years. The Joint Tax Committee essentially concurs with that estimate. We believe that even this relatively low figure is unrealistically high. A careful study by an expert in the field shows the probable revenue loss to be $200 to $250 million over the five year period.

A recent study by leading transportation economists (Temple, Barker and Sloane) concludes that each dollar withdrawn from a CCF for shipbuilding purposes provides $4.70 in direct, indirect and induced sales in the U.S. economy. In addition, 4.3 jobs are created for each shipbuilding job. For example, a $100 million shipbuilding project (the approximate cost of one ship) has an economic impact of $470 million and creates a total of 1,515 jobs in the shipyard, plus 1,212 additional jobs with the suppliers to the shipyard.

In view of the substantial economic benefits and employment that result from the present CCF program, we believe that repeal would produce related revenue losses, not quantified or considered by the Treasury Department or Joint Tax Committee estimates.

## Conclusion

I believe in an equitable tax program, but only through means which make good business sense. While the proposal for repeal of the CCF program was intended to close an unnecessary loophole, studies have shown that repeal would have a minimal effect on tax revenues and would result in related revenue losses. On the contrary, the CCF is in no way an unnecessary loophole, but an essential component of our national maritime and defense policy. What has been ignored in formulating the proposal is the serious adverse impact CCF repeal would have on the United States merchant marine fleet, on our shipyards, and on our national defense. The President's proposal has not been based on a thoughtful or thorough review of established policies and programs, such as the CCF, which are designed to foster the development and maintenance of a strong merchant marine capable of meeting this nation's commercial and military needs.

August 28, 1985

## RETENTION OF THE CCF PROGRAM IS VITAL TO THE NATIONAL DEFENSE

It is the declared policy of the United States that:

> It is necessary for the national defense and development of its foreign and domestic commerce that the United States shall have a merchant marine . . . (b) capable of serving as a naval and military auxiliary in time of war or national emergency, (c) owned and operated under the United States flag by citizens of the United States . . . (d) composed of . . . vessels, constructed in the United States and manned with a trained and efficient citizen personnel, and (e) supplemented by efficient facilities for shipbuilding and ship repair.

Section 101 of the Merchant Marine Act, 1936.

History before and after this declaration teaches us an American merchant marine, most particularly our domestic trade fleet composed of American-built and -manned vessels, is vital for national defense. In both World Wars it was this domestic trade fleet which provided the backbone of support for our war effort. The Harvard Report on "The Use and Disposition of Ships and Shipyards at the End of World War II" prepared for the United States Navy Department and the United States Maritime Commission, June 1945, states (at p. 90):

> The contributions of domestic shiping to national security have often been overlooked. . . . Actually, in both World Wars domestic shipping has furnished more ships than those employed in foreign trade. All the coastwise and intercoastal ships of over 2,000 DWT's were requisitioned for use in this War. . . .

Without the American ships in existence at the outbreak of both Wars, our efforts would have foundered before they began. American ships carried 80 percent of all the supplies required to support the Allied war effort in World War II; virtually all the supplies in the Korean conflict; and an estimated 97 percent of all the supplies sent to Viet Nam. The Congressional Budget Office in a report on "U.S. Shipping and Shipbuilding Trends and Policy Choices" in August 1984, states (at p. 45):

> both a review of history and a thoughtful consideration of present international conditions suggests that cargo shipping is vital to U.S. national security. Separated from trading partners and allies by long ocean routes, the United States relies on shipping to sustain its economy and to support almost any kind of military operation.

The current condition of the American merchant marine concerns those charged with our national defense. In 1984 the Secretary of Defense stated to the Secretary of Transportation (letter dated April 24, 1984, copy attached):

> By the late 1980s/early 1990s, the U.S. commercial fleet may not be adequate to support military dry cargo requirements. Should the surge shortfall increase as projected, we will have to increase government controlled shipping programs, take government action to reverse the decline in the U.S. commercial fleet, or both. Moreover, military sealift requirements are only a part of the total national security requirement for the U.S. Merchant Marine. Solutions to DoD military requirements alone will not necessarily assure our national security. It is essential that all national security requirements, encompassing not only DoD's military needs but also the security requirements of the civil economy and industrial base, be identified before program and legislative proposals are developed.

In response to the statement in Treasury II that the national security justification for subsidies of U.S. maritime construction is in doubt, Everett Pyatt, the Assistant Secretary of the Navy for Shipbuilding and Logistics, reaffirmed the national security justification for subsidy of the merchant marine (letter dated June 7, 1985, copy attached). He quoted the Joint Chiefs of Staff as follows:

> In any major overseas deployment, sealift will deliver about 95% of all dry cargo and 99% of all petroleum products. Ships from the U.S. merchant marine represent the largest domestic source of sealift, making them an important strategic resource.

He described Treasury II's statement as a "gross oversimplification of the role of the merchant marine," pointing out that the "most useful ships for military purposes are under U.S.-flag while the flags of convenience [ships] are used primarily to support the national economy rather than direct military support."

Key members of the House Armed Services and Merchant Marine Committees have recently urged that the CCF program be retained on national defense grounds. See attached letters dated August 1 and August 16, 1985.

The foregoing are the opinions of the people and the committees responsible for national defense. Recent events dramatically demonstrate the correctness of those opinions. In the Falklands War, Great Britain was faced with the task of dislodging hostile forces which had invaded its territory in the South Atlantic, many thousands of miles from home. Great Britain's ability to successfully conclude that war was the direct result of its ability to mobilize its merchant marine to carry the troops and supplies necessary to that endeavor. These ships were in existence under British-flag at the outbreak of hostilities.

THE SECRETARY OF DEFENSE
WASHINGTON, THE DISTRICT OF COLUMBIA

24 APR 1984

Honorable Elizabeth Hanford Dole
Secretary of Transportation
U.S. Department of Transportation
400 7th Street, SW
Washington, D.C. 20590

Dear Elizabeth:

As you know, the decline of the U.S. maritime industries over the past several years has generated significant interest in the Merchant Marine's capability to support the President's national security objectives. Our departments have been involved in two major maritime-related studies to quantify defense requirements--the DoD Sealift Study and the Navy/MARAD Shipyard Mobilization Base (SYMBA) Study. Although follow-on analyses to both studies are presently scheduled to be completed this spring, work on military requirements for dry cargo shipping has been completed. Enclosed is a statement of the dry cargo shipping objectives that underlie DoD's requirements and our current best estimate of the sealift necessary to meet those requirements.

The decline in U.S.-flag commercial shipping capable of carrying military unit equipment is of particular concern to DoD. We are doing much to fix the problem; however, your latest projections of shipping trends indicate a good part of the potential gains may be eroded by accelerated commercial developments. Thus, even assuming that the entire U.S. Merchant Marine is made available to support military requirements, we may not be able to meet DoD's limited policy objectives.

A Merchant Marine, even if it were capable of supporting military operations, may not be adequate to satisfy all of our national security requirements during a major conflict. I have not included the civil economy and the industrial base in DoD's statement of maritime requirements. For this reason, I propose we jointly develop a statement of national maritime requirements, encompassing not only DoD's military needs but also the security requirements of the civil economy and industrial base. We would use these total requirements as a basis for determining the adequacy of current U.S. maritime policies and, if necessary, for developing alternative programs and legislative proposals for submission to the National Security Council by July 1984.

Mr. William Sharkey, Director for Energy and Transportation Policy, OASD (MI&L), will be coordinating DoD participation. I request that you appoint an office within DOT to co-chair this effort with Mr. Sharkey. With your help, we could establish an Administration policy that would assure our overall national security. I welcome your comments and look forward to working with you on this important issue.

Sincerely,

Cap.

Enclosure

## Department of Defense Dry Cargo Shipping Objectives and Requirements

### DoD Dry Cargo Policy Objectives

The Department of Defense (DoD) policy objectives for meeting military dry cargo sealift requirements are:

- At a minimum, to maintain sufficient shipping capacity under U.S. government control and/or in the U.S. commercial fleet 1/ to meet the surge and sustaining requirements of that portion of a global war wherein allied shipping is not available.
- To obtain shipping assistance from our allies to meet U.S. military surge and sustaining requirements in their respective geographic areas.

Surge operations are defined as the movement of combat and support forces' unit equipment to a theater of operations. Generally, because of the required delivery dates of these forces, each ship can make only one trip. Sustaining operations are defined as the cyclical operation of all shipping to deliver resupply and ammunition to forces over the course of a conflict.

### Dry Cargo Shipping Requirements

The DoD military dry cargo required to be moved by U.S. sealift is derived from the Southwest Asia (SWA) portion of a global war. Under current global planning scenarios, DoD will rely on shipping assistance from our NATO and Northeast Asia allies to meet U.S. military surge and sustaining requirements in their respective geographic areas. To meet U.S. SWA requirements, sufficient shipping capacity must be available from U.S. sources to move about 800,000 short-tons of military unit equipment (UE) during surge operations and about 1.7 million short-tons of resupply and ammunition during sustaining operations. Delivery of that amount of cargo on time would require about 4.6 million deadweight tons (MDWTs) of shipping to be available for surge and an additional 3.3 MDWTs to be available for sustaining operations.

### Dry Cargo Shipping Trends

While the overall cargo capacity of the U.S. commercial fleet is projected to remain relatively constant, projected declines in commercial shipping capable of carrying military UE is of concern to DoD. In response to that concern, DoD is planning to increase significantly the surge shipping under government control.

---

1/ The U.S. commercial fleet is defined to include ships registered under U.S. flag and effective U.S. controlled (EUSC) ships owned by U.S. citizens and registered under foreign flags of convenience.

Recent developments in the commercial fleet, however, indicate even with these steps, the U.S. commercial fleet of the late 1980s/ear 1990's, may not be able to support adequately the military dry cargo requirements in the event of a war or national emergency.

The problem is meeting the surge requirement; sufficient capacity is expected to be available to meet sustaining requirements.

Figure 1 depicts the deadweight tonnage of surge shipping available today, the projected 1988 tonnage used in the DoD Sealift Study, and a recently revised MARAD projection for 1989-90. The projected decline in the UE shipping tonnage of the commercial fleet is offset by DoD's program to increase shipping tonnage under government control from the current 0.9 MDWTs to about 1.8 MDWTs by 1988 and by DoD's seashed and flat rack program. The latter program, under which U.S.-flag container ships will be modified during a contingency to carry unit equipment, will contribute an additional 0.8 MDWTs of UE shipping. Thus, DoD programs now planned or underway will provide about 2.6 MDTWs of UE-capable shipping by 1988. Nonetheless, we remain somewhat short of the requirement--substantially so if the latest MARAD projection proves accurate.

Conclusions

By the late 1980s/early 1990s, the U.S. commercial fleet may not be adequate to support military dry cargo requirements. Should the surge shortfall increase as projected, we will have to increase government controlled shipping programs, take government action to reverse the decline in the U.S. commercial fleet, or both. Moreover, military sealift requirements are only a part of the total national security requirement for the U.S. Merchant Marine. Solutions to DoD military requirements alone will not necessarily assure our national security. It is essential that all national security requirements, encompassing not only DoD's military needs but also the security requirements of the civil economy and industrial base, be identified before program and legislative proposals are developed.

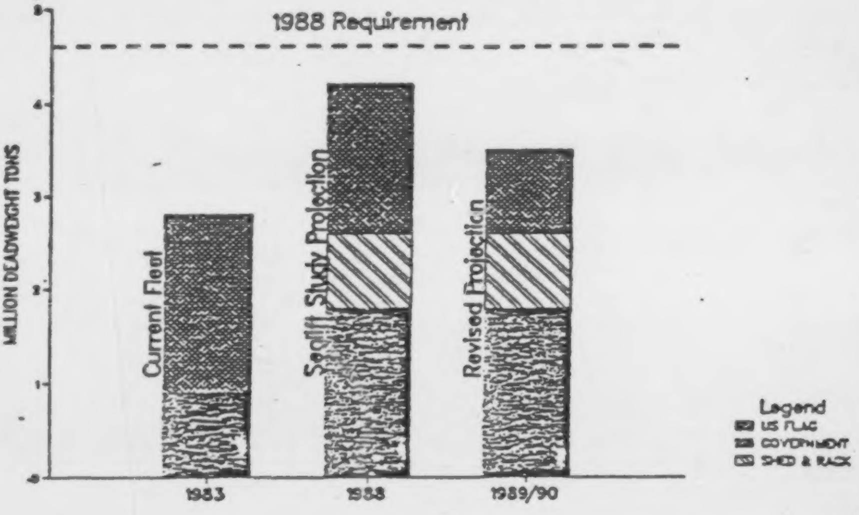

FIGURE 1
AVAILABLE UE CAPABLE SURGE SHIPPING

CASO NOTE: The requirements and resources charted in Figure 1 above relate to Merchant Marine dry cargo (liner) shipping. The legend can be more fully explained as follows:

"U.S. Flag" -- Privately owned U.S. flag merchant ships.

"Government" -- U.S. government owned merchant type ships.

"Shed and Rack" -- Privately owned U.S. flag merchant ships adopted for military use through installation of specially designed portable equipment such as Seasheds and Flatracks.

Fig. 1

DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20350

JUN 07 1985

The Honorable Ronald A. Pearlman
Assistant Secretary of the Treasury
For Tax Policy
Main Treasury
Room 3120
15th and Pennsylvania Avenue, N.W.
Washington, DC 20220

Dear Mr. Secretary:

The Treasury Department, in your report to the President "Tax Reform for Fairness, Simplicity, and Economic Growth", has misinterpreted the key defense role to be played by our U.S.-flag merchant marine. Currently, our military planning depends upon the U.S. merchant marine to provide more than two-thirds of the U.S.-flag sealift. In their Fiscal Year 1986 Posture Statement to the Congress, the Joint Chiefs of Staff stated:

> "In any major overseas deployment, sealift will deliver about 95% of all dry cargo and 99% of all petroleum products. Ships from the U.S. merchant marine represent the largest domestic source of sealift, making them an important strategic resource."

Volume II of your report, when explaining your proposal to eliminate the merchant marine Capital Construction Funds, states:

> "The special tax treatment of Capital Construction Funds originated, along with a direct appropriations program, to assure an adequate supply of shipping in the event of war. It was thus feared that because of comparative shipbuilding and operating cost disadvantages, peacetime demand for U.S.-flag vessels would not reflect possible wartime needs."

As justification for repeal of the special tax treatment for Capital Construction Funds, the proposal goes on to say:

> "A national security justification for subsidies of U.S. maritime construction is today very much in doubt. U.S. citizens own or control large numbers of ships registered in Panama, Liberia, and Honduras, that would be available to the United States in an emergency, and most U.S. allies possess substantial fleets of ocean going cargo ships that would be available in any common emergency."

This gross oversimplification of the role of the merchant marine misses the point that the most useful ships for military purposes are under U.S.-flag while the flags of convenience cited here are used primarily to support the national economy rather than direct military support. The conclusion that foreign flag ships would be available to support U.S. operations is not supported by fact or agreement. In fact this rationale is in direct contradiction with the President's recent statement on the merchant marine (attached).

In short any issues you may have with the Capital Construction Fund need to be approached as a matter of tax policy, not defense policy. I would be pleased to discuss this issue with you if you desire.

Sincerely,

Everett Pyatt

EVERETT PYATT
ASSISTANT SECRETARY OF THE NAVY
(SHIPBUILDING AND LOGISTICS)

Attachment

Congress of the United States
House of Representatives
Washington, D.C. 20515

August 1, 1985

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

We are writing to urge that an Administration proposal to abolish the Capital Construction Fund be withdrawn.

As members of the Subcommittee on Seapower and Strategic and Critical Materials we have come to appreciate the importance of the U. S. merchant marine to the national defense. The continuing shrinkage of the merchant marine is a matter of grave concern and it led the committee to report legislation, subsequently enacted, to create a Commission on Merchant Marine and Defense to study problems relating to transportation of cargo and personnel for national defense purposes in time of war or national emergency and the capability of the U.S. merchant marine to meet the need for such transportation. The commission is to make specific recommendations to foster and maintain a U.S. merchant marine capable of meeting national security requirements.

The Capital Construction Fund (CCF) provides significant financial incentives, through the deferral of taxes, for investment in the U.S. merchant marine. The fund has been an integral element of U.S. merchant marine policy for many years.

We believe that it is imprudent to dismantle the existing mechanism for fostering a merchant marine without a clear understanding of the effect of such action and without an alternative plan for maintenance of a merchant marine resource necessary for the national defense.

Accordingly, we urge that the proposal to abolish the CCF be withdrawn to allow the Commission on Merchant Marine and Defense to carry out its work and report its findings to you and to the Congress before making further changes in national programs to foster a U.S. flag merchant marine.

Sincerely,

Charles E Bennett
CHARLES E. BENNETT
Member of Congress

Floyd Spence
Floyd Spence
Member of Congress

COMMITTEES
ARMED SERVICES
SEAPOWER AND STRATEGIC AND
CRITICAL MATERIALS
PROCUREMENT AND
MILITARY NUCLEAR SYSTEMS

MERCHANT MARINE AND
FISHERIES
FISHERIES AND WILDLIFE
MERCHANT MARINE

TONY M. PAPPAS
ADMINISTRATIVE ASSISTANT

*Congress of the United States*
CONGRESSMAN ROY DYSON
224 CANNON HOUSE OFFICE BUILDING, WASHINGTON, D.C. 20515 (202) 225-5311

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(301) 645-4844

August 16, 1985

Honorable Dan Rostenkowski
Chairman
Ways and Means Committee
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

We are writing regarding the Department of Treasury's proposal to repeal the Capitol Construction Fund (CCF) program authorized under Section 607 of the Merchant Marine Act of 1936, as amended. As justification for repeal of this maritime program the Treasury stated that: "A national security justification for subsidized U.S. Maritime Construction is today very much in doubt."

As Members of both the House Armed Services Subcommittee on Seapower and the Merchant Marine Committee, we disagree with this conclusion, as has the Navy, and believe it is premature and inappropriate to repeal the CCF program at this time.

Less than 10 months ago, the Congress passed and the President signed into law legislation establshing a Commission on Merchant Marine and Defense comprised of seven Presidential appointees. This Commission is directed to study problems concerning transportation of cargo and personnel for national defense purposes in time of war or national emergency. The Commission will also evaluate the adequacy of the shipbuilding mobilization base in the U.S. to meet the needs of naval and merchant ship construction in time of war or national emergency. The Commission is to make specific recommendations to foster and maintain a U.S. merchant marine capable of meeting national security requirements.

The CCF, which assists merchant marine companies in the construction, reconstruction or acquisition of ships, has been an integral element of U.S. maritime policy for many years. It is also one of only two remaining maritime programs and clearly is one which the Commission will examine in the course of developing its comprehensive program to assure an adequate merchant marine.

We believe that the serious exceptions that the Navy Department has raised about Treasury's proposal, coupled with other recent government studies and reports supporting the national defense role of the U.S. merchant marine, compel the conclusion that no action should be taken to change the CCF program at least until the Commission has had an opportunity to examine this issue in the context of overall national maritime and defense policy.

Therefore, we strongly urge that the Committee postpone action on this proposal to abolish the CCF program.

Sincerely,

Roy Dyson
Roy Dyson
Member of Congress

Tommy Hartnett
Thomas F. Hartnett
Member of Congress

Thomas M. Foglietta
Member of Congress

William Carney
William Carney
Member of Congress

Herbert H. Bateman
Member of Congress

Solomon P. Ortiz
Solomon P. Ortiz
Member of Congress

The CHAIRMAN. Absent CCF and some very minor other construction subsidies that exist, in your judgment would there be any significant commercial shipbuilding in the United States?

Mr. DONOHUE. Without the CCF?

The CHAIRMAN. Yes; and there are a few other minor subsidies, but by and large CCF is the biggest one. Would there be any significant commercial shipbuilding in the United States?

Mr. DONOHUE. I think yes. I think we are always going to have to have commercial shipbuilding in the United States. Without the CCF, it's going to be far more costly on our companies to meet the massive amounts of capital necessary. Ships now are $100 million or more. Our company has a little over $200 million in net worth. To accumulate these funds, we need the CCF. Otherwise, it's extremely costly for us.

The CHAIRMAN. Now why wouldn't most of the commercial shipbuilding go overseas without CCF?

Mr. DONOHUE. Without the CCF, those companies who can go overseas would look to overseas yards to do their building. Some of us can't do that.

The CHAIRMAN. Why?

Mr. DONOHUE. Because we are domestic carriers.

The CHAIRMAN. In terms of your Jones Act limitation.

Mr. DONOHUE. Yes.

The CHAIRMAN. I understand that. I was counting that as a subsidy. It's not a tax subsidy, but it's a requirement that you have to build here if you want to be in the coastal trade.

Mr. DONOHUE. Yes.

The CHAIRMAN. Short of that and the CCF, would most ships then be built overseas?

Mr. DONOHUE. Yes.

The CHAIRMAN. If you could participate in a coastal trade and build your ship in Korea and if you had no capital construction fund and there were no tax incentives, given that situation, would commercial shipbuilding continue to exist in this country in any significant quantity?

Mr. DONOHUE. I don't think so.

The CHAIRMAN. Senator Long.

Senator LONG. It's unfortunate that the CCF has had some unnecessary problems because it originated in the Commerce Committee. I was a member of the Commerce Committee and chairman of the Merchant Marine Subcommittee at the time. I was also chairman of the Finance Committee. I explained it to the members of the Finance Committee, and I had support of both the Finance Committee and the Commerce Committee when it came up. We had some opposition from Senator Williams of Delaware, but that was all.

The majority of the members on the Finance Committee did not support Senator Williams' position so there was no problem passing the CCF provision But in subsequent legislation, for example, with the investment tax credit, they failed to take the CCF into account, because it was not drafted as part of the Internal Revenue Code. We constantly had difficulty with the CCF because it fell under the jurisdiction of the Commerce Committee.

I suspect that that is part of the trouble now with the recommendations to repeal the CCF. The tax-writing committee on the House side did not have the same association with it that the Finance Committee had with it over here on the Senate side. Here, at least, you had somebody who understood the purpose of the CCF and what it was all about.

As it stands today, other than with regard to the areas covered by the Jones Act requiring ships to be built in American yards, if you are talking about international trade on the high seas—hauling large amounts of cargo—I can't see where the subsidy would make it possible for us to build ships in American yards at all. I mean the subsidy we have is not enough, not near enough.

Mr. **Donohue**. That's correct. There really is no subsidy.

Senator **Long**. For example, I went through one of the Korean shipyards this last summer. They were building some beautiful, big ships. They are very good, high quality ships. People tell me, for example, that the timing pieces, the equinomiters, are the best equinomiters in the world. Is that correct?

Mr. **Donohue**. The Korean yards have most of the business, I understand.

Senator **Long**. What was that?

Mr. **Donohue**. I understand that the Korean yards now have most of the business and they are doing very good work.

Senator **Long**. They are also building diesel engines that were designed in Europe. They build the European design, but they machine them to a much finer degree than diesel engines built anywhere else. Thus, they have better engines, better timing pieces, and good ships. We can't begin to meet their price, even with the available subsidy. They are working for $1.60 an hour and are doing a good job. That is what you are up against, isn't it?

Mr. **Donohue**. Yes.

Senator **Long**. If you are talking about trying to compete with anybody in the world market, the repeal of CCF is overkill. You can't compete the way it is now. Isn't that about the size of it?

Mr. **Donohue**. That's correct. Yes.

Senator **Long**. At least in the coastal trade, you cannot compete, but can at least survive. But other than that, you can't make it at all.

Mr. **Donohue**. That's right, Senator.

Senator **Long**. I would hope that before somebody tries to repeal the CCF, they will at least take a look at your profit and loss and see if anybody in your crowd is making enough money to justify a tax increase.

The whole idea of a minimum tax, for example, is if somebody made a lot of money he ought to pay some tax. But I have difficulty understanding why your industry ought to have a tax increase. You are going through some tough times.

Mr. **Donohue**. Oh, very difficult, very difficult. Particularly out in the Pacific. This is why we would hope that the CCF would be considered in light of overall maritime policy and not be considered as part of this tax reform legislation.

Senator **Long**. Thank you very much.

The **Chairman**. Senator Matsunaga.

Senator **Matsunaga**. Thank you, Mr. Chairman.

And welcome, Mr. Donohue. I'm sorry I wasn't here to listen to your testimony, but I have read it. And I wish to extend special greetings for the reason that Matson plays such an important part in the economy of the State of Hawaii, and let me assure you that as a Senator from Hawaii people do appreciate your service out there.

Mr. **DONOHUE**. Thank you, Senator.

Senator **MATSUNAGA**. And you have characterized the capital construction fund program as a tax-deferral program that enables ocean carriers to accumulate capital necessary to ensure timely vessel replacement and maintenance. In your view, would Matson or any other domestic carrier be able to accumulate this capital without the CCF program?

Mr. **DONOHUE**. I partly answered it in a question that Senator Packwood gave. I believe that, yes, eventually the capital would have to be accumulated if we were going to be able to stay in business. It would take us longer and it would be more costly.

Senator **MATSUNAGA**. And would it be accurate to state that since a vessel's tax basis is reduced when tax deferred earnings are deposited in a CCF, this resulting reduction in depreciation causes the deferred taxes to be paid in full over the depreciable life of a vessel?

Mr. **DONOHUE**. Oh, yes, yes. They definitely are totally repaid. The CCF deposit can be viewed as if it were advance depreciation. If you deposit the funds and then take them out to build a ship, you get the value of your depreciation right off, when you deposit the funds. You don't have to wait for the life of the vessel to recover the cost as with other assets.

Senator **MATSUNAGA**. And, as you know, the Treasury Department has asserted that even if a capital construction fund subsidy is justified, it would more appropriately be provided in the form of a direct spending or regulatory program. Would you care to comment on this?

Mr. **DONOHUE**. We don't really think that direct subsidies are a reality in the current political world. We think that the CCF, which is a sheltering of profits, a putting away of profits for reinvestment in the company, is a much more efficient way; a reinvestment in vessels is a much more efficient way to develop the equipment needs rather than taking a handout from the Government which the Government never gets back. CCF is a tax-deferral mechanism, as we say. It's an interest-free loan, if you will, from the U.S. Government, and it's paid back in full through the loss of depreciation when the vessels are finally built.

Senator **MATSUNAGA**. Well, I thank you for appearing before this committee. And if you see my good friend, Bobby, give him my best.

Mr. **DONOHUE**. I sure will.

Senator **MATSUNAGA**. Thank you.

The **CHAIRMAN**. Thank you, Mr. Donohue. You make a good presentation.

Mr. **DONOHUE**. Thank you, Senator.

The **CHAIRMAN**. We are adjourned.

[Whereupon, at 11:20 a.m., the interview was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

ARTHUR ANDERSEN & CO.

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October 4, 1985

Honorable Bob Packwood
Chairman
Committee on Finance
U.S. Senate
SD-219
Washington, D.C. 20510

Subject: Minimum Tax
Submitted in conjunction with hearings
to be held October 9, 1985

Dear Mr. Chairman:

The President's tax reform proposals, submitted to Congress on May 29, 1985, describe an alternative minimum tax (AMT) applicable to both individuals and corporations. The Tax Reform option submitted to the Ways and Means Committee for use in its current mark-up of tax reform legislation ("Staff Proposal") contains an expanded AMT, again applicable to both individuals and corporations.

The Arthur Andersen Worldwide Organization is the world's largest accounting and consulting organization. We take no position either advocating or opposing these proposals or other minimum tax proposals. Rather, the comments submitted in this letter are intended to provide observations and suggestions on several technical issues not covered in the President's proposal to the drafters of any AMT proposal the committee might adopt. These comments will address both the corporate and the individual AMT, and are submitted for the hearing record on the minimum tax. Those hearings will be held October 9, 1985. In addition, these comments will refer, where appropriate, to several legislative AMT proposals already introduced in the House and Senate, including H.R. 2424, S. 956 and S. 973.

## INTRODUCTION

The AMT proposals pose several problems, both structural and conceptual. The structural defects arise from the mechanics of the tax, and include problems associated with net operating losses, exemption amounts and the rate and base of the tax. The conceptual problems arise largely from the failure of AMT proponents to articulate the interaction of the AMT with the regular income tax. Principal among these defects are the absence of any mechanism to assure that taxpayers will not lose the value of the investment tax credit, the lack (in the President's plan) of any flexibility in determining AMT taxable income, and the potential (particularly in the legislative proposals) for double taxation.

An overall issue raised by the Staff Proposal is whether it makes sense to bring the rate of minimum tax so close to the normal rate of tax that a much wider universe of taxpayers not only have to compute it, but are likely to have to pay regularly under it, rendering the regular tax system a nullity. (The Staff Proposal contains a 25 percent AMT and a 35 percent top marginal rate on both individuals and corporations.)

## CONCEPTUAL FRAMEWORK

### Rate Differential -- Purpose and Scope of a Minumum Tax

Some of the proposals would not only expand the minimum tax base, but also would increase the AMT rate to as much as 25 percent. The Staff Proposal would raise the rate to 25 percent while at the same time reducing the maximum individual and corporate rates to 35 percent. This compression of tax rates raises a number of important issues.

The first issue that the Committee must decide is the reason for a minimum tax in the context of a broad-based low rate income tax system. This issue is highlighted by the convergence of both the individual and corporate rates under the Staff Proposal. The minimum tax was originally enacted to insure that those few individuals who paid little or no tax, primarily because of tax shelter investments, would pay some tax. It has been expanded over the years and today can best be described as serving the purpose of insuring that those relatively few who do not pay what is perceived to be their fair share will pay some significant amount of tax.

It would seem that the increase in the rate of AMT to 25 percent in a 35 percent mainstream world would put large numbers of taxpayers on the AMT even though they would pay significant taxes under the regular tax (as much as 24 percent of book income). To put this in perspective, a corporate taxpayer with $150 million of book income and $100 million of taxable income will pay AMT, even though its regular tax would be $35 million. The question is whether this is what the minimum tax is about. To put the question another way, the process of changing the Code so that it imposes a broad-based low rate income tax system that people believe is rational will be painful and disruptive. Does it make sense to go through the pain and disruption to make the tax system one that will be, in the eyes of some, a rational system and then impose a minimum tax that not only raises more money than ever, but is so broad that the rationally structured reforms are rendered inoperative?

Under a broad-based minimum tax, it is quite possible that most utilities, timber producers, extractive and heavily capital intensive manufacturing companies seldom would be able to file on the ordinary tax rate system, but would be permanently on the AMT. This seems an odd result, particularly if the incentives that have enabled them to maintain productivity are vastly reduced.

The second issue is whether the additional burden imposed on taxpayers will further the policy objectives of the proponents of expanded minimum taxes. The proposed AMT imposes an additional burden on all taxpayers that have preferences in sufficient amounts that they reduce their income tax liability. Under an expanded AMT, the additional burden on a greater number of taxpayers is, of course, the necessity of computing tax twice, once under the regular tax and again under the AMT. Originally, only a limited number had to make these computations and these were generally fairly sophisticated individuals and corporations. Even today, with the individual AMT rate at 20 percent and the top individual rate at 50 percent, a growing but manageable number of individuals must make the computations.

As rates converge, however, more and more taxpayers, both individual and corporate, will have to make the computations. The Committee should determine how many will have to bear this burden and whether this added burden on so many is worth it to tax those, who, in any event, may be paying taxes of as much as 24 percent of book or personal income. An added and serious burden is that each time an investment decision is made a separate AMT computation will have to be made, projected many years into the future.

## STRUCTURE OF THE TAX

Generally, the President's AMT proposal is modeled on the current law, as is the Staff Proposal. First, regular taxable income before net operating losses (NOLs) for the year is determined. That amount is reduced by any allowable corporate AMT NOL deduction. The taxpayer then adds all applicable AMT preference items (exclusive of an exemption amount) to determine the alternative minimum taxable income (AMTI) base. The appropriate rate then is applied to AMTI to compute the AMT liability. The only credit permitted against the AMT liability is the foreign tax credit, subject to special limitations. The tax payable would be the greater of the AMT liability (as reduced by the foreign tax credit) or regular income tax liability (as reduced by all allowable credits). Each component of this model raises issues that could lead to inequities.

AMT net operating loss -- All of the outstanding proposals permit an AMT offset for NOLs, determined in a special manner different from the regular rules. The objective of this AMT NOL provision is to permit taxpayers to receive only the benefit of actual "economic" losses (i.e., NOLs excluding the designated preference items) when computing the AMT base. In practice, the AMT NOL provision would have the effect of reducing the value of NOL carrybacks and carryovers computed for regular tax purposes, thereby reducing the NOL offset against the AMT. Notwithstanding the objective of this special AMT NOL rule, its operation can be complex and can lead to extremely unfair results.

This problem will be particularly acute in the transition year of tax reform. Assuming that the AMT goes into effect in 1986, there should be no requirement that any pre-1986 NOL carryovers be "cleansed" of preferences. This was the approach adopted in the 1982 modifications of AMT, and represents a fair resolution of this problem. Otherwise, the corporation would be denied the tax benefit of preferences that were lawful in the year they arose, but that could not be fully utilized.

Exemption amount -- With the exception of H.R. 2424, the proposals provide a threshold exemption to allow individuals, small businesses or companies that use few preferences relief from the complex AMT rules. To assure equity, we urge the drafters to provide an exemption amount.

Rate -- As discussed above, the interaction of the AMT rate and base with the regular income tax will require careful engineering, particularly if the maximum rate is reduced as low as 33 or 35 percent. The Senate bills have a broader base than the President's proposal, but impose a lower rate on that base. (The Senate bills propose a 15 percent rate; the President suggests 20 percent.) By contrast, the Staff Proposal and H.R. 2424 impose a 25 percent rate on a very broad base. In effect, the Staff Proposal and H.R. 2424 could operate as a penalty tax or a surtax on preferences, since the base will almost always be substantially broader than the income tax base and the tax paid at a rate of 25 percent on a broader base generally approximates the proposed corporate rate of 33 or 35 percent and the proposed top individual rate of 35 percent on a narrower base. Thus, great care should be taken to assure that the preferences that comprise the base do not undermine the objectives of capital recovery or other allowable timing differences that permit deferral (such as the completed contract and installment methods of reporting).

Base and preferences -- Generally, we take no position on the inclusion of particular preferences in the base, so long as the potential for double taxation is eliminated through an operable crediting device, basis adjustment or other mechanism (to be discussed below). Some of the preferences, however, are based on faulty premises, and should be refined or eliminated.

Real economic losses/tax shelters -- In what we consider to be an excess of zeal to deal with problems created by tax shelters, the Staff Proposal would treat as a preference, and thus tax, the net loss from a trade or business activity in which the taxpayer did not materially participate in management or provide substantial personal services. The thrust would appear to be to impose a penalty tax on passive investors.

The net result of this proposal would be to place a substantial impediment in front of anyone considering an investment in which there might be a risk of incurring actual cash losses (not merely book entries) in the early years even though the investment has a sound economic base that is not tax motivated. The impact on investment of such a proposal is not something that we claim to be able to estimate, but, intuitively, it could be enormous. It creates a situation where an investor could be taxed even though a real business investment has deprived him of the cash with which to pay the tax. This situation is distinguishable from what some describe as a traditional tax shelter investment which, in the early years, provides an investor with tax benefits that exceed his cash investment in the deal. The treatment of real losses as a preference can tax an individual even when his cash investment exceeds his tax benefits.

Non-cash items -- Some of the minimum tax proposals, particularly H.R. 2424, would include in the tax base certain non-cash items. H.R. 2424 would treat increases in vested pension or profit-sharing benefits, including vested benefits under self-employed (HR-10) plans as preferences. It would also add items for which the taxpayer receives no disposable income, such as employer-paid health and life insurance.

These provisions obviously pose difficult or novel technical and policy questions. For example, it would seem quite unfair to tax an individual on income that be does not receive, particularly at a rate as high as 25 percent. Many of those items would also be taxed a second time at ordinary rates when the amounts are actually collected by the individual. If pension benefits become a preference, then identifying and valuing the increase in vested benefits would pose problems for both employees and employers. The preference would be especially onerous for individuals participating in plans with 10-year "cliff" vesting or the more common 4/40 plans, in which 40% of accrued benefits vests after four years of employment.

Employees would be required to rely on their employers to provide the amount of the potentially taxable item each year. This would be burdensome for employers because they generally do not maintain benefit accounts on an individual basis. Moreover, the proposal provides no guidance on proper valuation of the benefit. Presumably, an actuary would make this determination. An annual actuarial analysis of the plan, however, would be very costly, particularly because it would entail a determination for every individual participant and not merely a statistical sampling. Even greater valuation problems would arise if the category of non-cash preferences were to include the broad category of "fringe benefits."

Net interest expense -- Another potential item of tax preference that we oppose is the President's proposal to include a portion of net interest expense in the AMT base. We believe that this preference is conceptually flawed. If it were nonetheless included in the AMT base, it is also structurally flawed as currently drafted.

The preference for net interest expense in the President's proposal is conceptually flawed. We are well aware of the Treasury's concerns about the tax benefits associated with the combination of accelerated depreciation and interest expense deductions. We acknowledge that that interaction can, indeed, result in front-loaded deductions, and that many would argue that current law provides a less than perfect measure or matching of interest income and expense. If those problems are the Treasury's primary concerns, however, making arbitrary assumptions about the relationship of debt to investment is an inappropriate means of solving the perceived problem.

The proposal assumes that the first dollar of debt a corporation incurs is attributable to personal property placed in service after 1985. We believe this is an inappropriate assumption. In fact, the debt may actually be incurred for acquisition of real property, expenses associated with inventory, construction costs, or other similar items. In addition, even though the preference is measured in terms of personal property placed in service after 1985, there is no correlative "fresh start" for tracing the interest expense. Thus, the interest expense attributable to pre-1986 debt is swept into the AMT base, even though there may, in fact, be little, if any, inflation premium associated with the debt, and even though the debt is actually "old and cold."

The structure of the net interest preference is peculiar, at best, and is unreasonably complex. First, the net interest is measured in terms of interest income. Other forms of investment income, such as dividends and rents, are excluded. This would tend to create a bias in favor of investing in interest-bearing instruments, and away from equity investments. Since the entire reform process is aimed at creating a "level playing field," the creation of this type of bias seems unwarranted.

After computing net interest expense, the taxpayer will be required to compare that amount with cost recovery expenses computed under two different methods, the proposed Capital Cost Recovery System (CCRS) and the proposed Real Cost Recovery System (RCRS). We find this measurement to be unnecessarily complex. Probably its most objectionable feature is the use of the RCRS system in the AMT context. We believe it is inappropriate to require measurement of any preference to be cast in terms of a complicated structure that has little other application in the entire tax system.

(Note that cost recovery preference amounts for post-1985 investments in real property and certain leased personal property are also measured in terms of RCRS amounts. The same objections to RCRS as a measuring device would also apply to those cost recovery preferences.)

Windfall recapture -- We would find inappropriate and oppose any suggestion that anything like the so-called "windfall recapture" contained in the President's proposal be treated as a preference. We believe that this provision itself is highly questionable. If it is adopted for regular tax purposes, then there is no need to aggravate the inequity of excessively fast recoupment of prior depreciation deductions by including the recapture amount in the minimum tax base, as well. The President's plan, by distinguishing the measurement of pre-1986 accelerated depreciation preferences from post-1985 preferences, provides for capturing some of the benefits associated with ACRS deductions without extending the preference to include the windfall recapture. Many argue that the windfall recapture is in the nature of a retroactive tax. We see no reason to compound the retroactive aspect of the recapture by adding it to the AMT base.

## Flexibility

Under current law, individuals may make special elections to take certain preferences out of the AMT base and to include them, instead, in the regular tax base (IRC Section 58(i)). S. 956 and S. 973 go well beyond current law, and propose that a corporate taxpayer be permitted to elect that any item of tax preference be restored to regular tax computations, and forgone as a preference. We believe this added flexibility is warranted so that taxpayers will not be unduly penalized, and that it should be applied to individuals. Provision for an annual, irrevocable election for that year would curtail potential abuses. H.R. 2424 permits such an election, but only for a very limited number of preferences. We suggest the approach of the Senate bills as providing the maximum flexibility.

## Coordination with the Income Tax

Perhaps the most glaring problem in the proposals, other than the Staff Proposal, is the absence of a mechanism for reflecting AMT paid in determining regular tax in subsequent years. A taxpayer potentially is taxed twice on the same income, particularly when allowable income-deferral accounting methods such as installment sale or completed contract reporting have been used. Note, however, that the Staff Proposal currently provides insufficient data to evaluate the coordination mechanism. We urge the drafters to craft this device carefully, lest undue complexity be created by means of a cumbersome credit and carryover mechanism.

H.R. 2424, S. 956 and S. 973 provide an example of the potential for double taxation. Each bill treats completed contract reporting as a tax preference. The preference amount is the excess of the income that would have been reported if the percentage of completion method of reporting were used over the amount recognized using the completed contract method.

Assume that a taxpayer's construction project would take three years to complete and that tax reporting is on the completed contract method. In the first two years, the AMT base would include the excess of the amount that would have been reported under the percentage of completion method over the amount reported using the completed contract method. Then, in the third year, when the contract is completed, the entire profit on the contract would be taxed for regular tax purposes. Thus, AMT could be paid on two-thirds of the profit and regular tax paid on the entire profit from the contract. The amount of regular tax on the profit would not be reduced by the amounts attributable to AMT paid in prior years. The effect is that the same income is taxed twice, under two different methods. Thus, the so-called "alternative" can be, in effect, a surtax on specified preference items instead of a so-called minimum tax. In this example, the total tax on the income from the contract would be 51.7 percent, compared to the Staff's proposed regular income tax rate of 35 percent (and 25 percent for the AMT).

Accordingly, a mechanism is needed to recognize that some AMT already may have been paid on deferred income that was subject to tax in the AMT year and that is being recognized in the current year. This mechanism could take various forms, such as a credit, a basis adjustment, or a multiyear averaging approach. The Staff Proposal adopts the credit approach by allowing the minimum tax liability to be carried forward as a credit against regular tax liability in future years. Without a relief mechanism like this, the additional complexities of tax planning could become extraordinary as taxpayers attempt to forecast their income and tax positions from year to year to avoid the harsh double tax result. Also, uncertainty would be added in financial-statement accounting for deferred taxes in that there would be increased likelihood that taxes provided under present accounting rules at the AMT rate later would be adjusted to the higher regular corporate rate or that benefits reflected at the higher corporate rate would prove to be worth only the lesser AMT amount.

Investment Tax Credit

Many taxpayers are currently in a position where, for a variety of reasons, they have been unable to make full current use of the investment tax credit (ITC), and are therefore in a carryover position. Since these carryovers have a 15-year life (after a three year carryback), it is important that their value to the taxpayer not be eroded or obliterated solely because of the AMT. If, in fact, Congress repeals the ITC, it will be all the more important for taxpayers in a carryover position to retain the greatest possible value for their credits.

The authors of the President's package have indicated no intent to interfere retroactively with carryovers related to property placed in service before 1986, and we see no reason why the AMT should change that balance. Decisions to invest in the assets to which the carryovers relate were based on incentives available at the time of the investment, so the integrity of those investment decisions should be preserved. Moreover, the President's plan rightly expresses no intent to eliminate the carryovers.

Accordingly, we would propose that some mechanism be adopted to preserve the value of ITC carryovers for those taxpayers who will be subject to AMT. The purpose of the proposed AMT is to "minimize the number of high-income corporations paying little or no tax as a result of heavy utilization of the tax preferences included in the alternative minimum tax base ..." (President's proposal, Chapter 13.04, page 337 (emphasis added)). Under current law, a company (as well as an individual) can minimize its tax liability, not only through use of any of the tax preference items included in the AMT base, but also through the use of a carryover of investment tax credit. If ITC is not allowed to offset the AMT, a taxpayer's carryover will be unavailable to reduce taxes in any given year. This result retroactively affects investment decisions. We believe this effect is contrary to the intention of the proposal.

For example, it is quite clear that the new proposed AMT could apply even if the taxpayer had no tax preferences. Assume, for example, that a corporation had no tax preferences and net taxable income of $3,000,000. In this situation, there would be regular income tax of approximately $1,000,000 (assuming the proposed 33 percent rate). The current investment tax credit rules would allow a maximum offset of $850,000 to that tax liability, leaving a net tax of $150,000. Under the President's proposal, the AMT would be 20 percent of taxable income or $600,000 (or $750,000 under the Staff Proposal). The taxpayer, in the absence of an AMT crediting mechanism for the ITC carryover, currently would lose the benefits of the carryover, expend a carryover year, and, even with no tax preferences, be required to pay the higher AMT. The frequency with which this situation could arise obviously increases under the Staff proposal where the minimum tax rate would be 25 percent. This seems an undue penalty.

Either of two mechanisms could correct this problem. First, a symmetrical rule could be adopted, under which an ITC carryover would offset 85 percent of AMT liability. Alternatively, a lesser percentage than 85 percent could be allowed as a credit against AMT liability.

In the example above, a carryover could offset 85 percent of AMT liability, or $510,000, resulting in a net AMT of $90,000. Utilization of the ITC could be limited so that net tax liability could not be reduced below the net regular tax liability of $150,000 in our example. This treatment would result in the fuller use of ITC carryover apparently intended under the proposal and would not interfere with the integrity of the AMT since it is designed to tax use of tax preference items, not deny ITC carryover.

If, in our example, $3,000,000 of preference items reduced the taxpayer's income down to the $3,000,000 of taxable income, the taxpayer would have an AMT liability of $1,200,000 (20 percent of $6,000,000). In this case, the taxpayer would have no opportunity to utilize its ITC carryover. However, if the taxpayer was allowed to offset its ITC carryover against 85 percent of its AMT liability ($1,020,000), it would result in a net tax liability of $180,000 ($1,200,000 less $1,020,000), which would exceed the taxpayer's net regular tax liability of $150,000, so the $180,000 AMT liability would be paid.

Allowing a full AMT offset for ITC carryovers is, in our judgment, a valid approach to the preservation of the value of the carryover. If that approach is not followed, then the rule of current law would provide a means of retaining some of the value of the credit carryover. Current law provides that, to the extent the AMT imposed on noncorporate taxpayers prevents use of ITC in any given year, the amount of ITC that could have been used absent the minimum tax provisions will not be lost. (I.R.C. Section 55(c)(3).) This provision can be illustrated by the following example:

| | |
|---|---|
| Regular Tax | $20,000 |
| ITC | $10,000 |
| Alternative Minimum Tax | $16,000 |

The taxpayer will pay $16,000 of tax. Therefore, he will only "use" $4,000 of ITC, rather than the $10,000 he has available. The taxpayer's carryover will not be reduced by the $6,000 of unusable ITC in that year. This result is fair, since reducing the ITC carryover in the above example by the full $10,000 would effectively result in a retroactive repeal of $6,000 worth of ITC -- a result clearly not intended by the proposals. To prevent this unfairness, the AMT drafters should ensure that only the ITC carryover allowed to reduce a corporation's tax liability from the regular tax to the level of the alternative minimum tax be "used" in any given year. This is the approach applied to the noncorporate AMT in the "General Explanation of the ... Tax Equity and Fiscal Responsibility Act of 1982" ("TEFRA Bluebook"), and we believe that it has valid application to corporate taxpayers, as well.

A second, less cumbersome means to assure the use of the carryover would be a simple amortization rule. Under this approach, the carryover would be amortized over its remaining life at January 1, 1986 (or whatever the effective date of ITC provisions, if any, might be). Then, the amortized amount could offset AMT. There would be no change to the carryover rules for regular tax purposes. For example, a carryover of $1 million with a 10-year period remaining would offset minimum tax at $100,000 per year. This would afford the taxpayer full use of its ITC carryover, while preserving the integrity of the AMT.

Solutions, such as those proposed in the Staff document, that permit the credit to be used as a credit carryover against regular tax are not solutions because the taxpayer will never be on the regular tax. This is because the investment tax credit carryovers will perpetually reduce the regular tax below the AMT. The taxpayer will pay the AMT and not reduce the investment tax credits which will carryforward to the next year, and so on.

In any event, it should also be noted that there is precedent for permitting an ITC carryover to offset AMT liability. The Miscellaneous Tax Act of 1980 (P.L. 96-603) (the "Act"), amended the code to permit the use of an ITC carryover against the AMT liability. That Act provided that nonrefundable tax credits could offset the AMT for noncorporate taxpayers when the credits were associated with an active trade or business.

The Finance Committee Report under the 1980 Act stated a concern that, "a taxpayer may not currently be able to take full advantage of otherwise allowable tax credits for the current year even though the taxpayer has few or no tax preferences." This unfairness would exist under the proposed minimum tax since the AMT may effectively tax use of ITC carryover, the very item that should remain unaffected by the AMT, rather than the tax preference items themselves. In order to avoid this unfairness, some offset of ITC against the AMT should be provided. While the 1980 allowance of the credit offset against AMT was repealed in TEFRA, the TEFRA Bluebook points out that the repeal of the AMT offset was intended as a simplification of taxes for noncorporate taxpayers. Since corporate taxpayers have used the ITC carryover rules routinely for many years, there is no valid simplification issue that should affect a decision to permit ITC to offset AMT.

Finally, under no circumstances should an ITC carryover year be completely lost when AMT applies. If carryovers cannot offset AMT, then at least the carryover period should be extended. Since the value of the carryover will diminish because of the time value of money, a longer carryover period appears to be an appropriate accommodation.

Current law provides an ITC carryforward of 15 years (after a carryback of three years). The 15-year carryover rule should be extended. The proposal does not indicate an intent to diminish ITC carryovers attributable to pre-1986 assets. However, the application of the proposed AMT (without the changes we suggest) will clearly limit the ability to use an otherwise permissible amount of ITC carryover in any given year and will thus extend the time needed to use up ITC carryovers. While the AMT will delay utilization of ITC carryovers, it should not eliminate them altogether solely by reason of a time limit. Therefore, at a minimum, the 15-year carryover period should be extended for each year in which the taxpayer is in an AMT position.

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We appreciate the opportunity to file these comments. Should you wish further information, please do not hesitate to call me at the number shown on page one or, in my absence, Linda Goold (862-3103).

Very truly yours,

ARTHUR ANDERSEN & CO.

By Byrle M. Abbin
Byrle M. Abbin

1985

## Statement of Martin Neil Baily[1]

Senior Fellow
The Brookings Institution
prepared for the
Committee on Finance
U.S. Senate
October 9, 1985

I am pleased to present this written testimony on the appropriate treatment for research and development (R&D) expenditures under a corporate minimum tax. This testimony will draw on a study of the economics of this issue undertaken by me together with my colleague Robert Z. Lawrence. This study, with an analysis of the legal and accounting arguments to support the expensing of R&D, prepared by Barbara Felker and Paul Oosterhuis of the law firm of Hogan and Hartson, was commissioned by the Coalition for the Advancement of Industrial Technology. I request that the complete document be made part of the record. My statement will highlight the major economic points.

The President's recent tax plan proposed the adoption of an alternative minimum tax on U.S. corporations. This plan specified that R&D costs were an allowable business expense for the purpose of calculating income subject to the minimum tax, but several of the minimum tax proposals from the Senate and the House would require instead that corporations amortize their R&D costs over five or more years. This is the case, in particular, for the recently released tax reform proposals issued by the staff of the House Ways and Means Committee. The Ways and Means staff would impose a 25 per cent minimum tax, requiring the amortization of R&D over five years. They also hit the R&D tax credit very hard, so the overall impact of their proposal would be to create a serious disincentive to the development of new technologies.

I will argue here that if there is to be an alternative corporate minimum tax, it should allow companies to expense R&D expenditures in computing their income for minimum tax purposes.

The economic case for expensing is based on four propositions.

(a) Amortization would impose a dramatic tax penalty on companies with high levels of R&D spending in the first few years after a minimum tax was introduced. Most of these companies are already paying high effective tax rates. There would be a continuing serious tax penalty on companies with rapidly growing R&D spending.

(b) Whereas current tax law provides an important positive incentive for companies to perform R&D, a minimum tax that required amortization of R&D expenditures would convert this to a substantial penalty and reduce R&D spending.

(c) Companies are required by the SEC to expense R&D expenditures for financial reporting purposes. Thus no company is reporting higher profits to its shareholders than it reports for tax purposes as a result of the treatment of R&D costs.

(d) Amortizing R&D expenses over five or more years would be a move away from true economic depreciation because seven out of eight R&D projects fail and create no asset of value to the company.

## The Tax Penalty on R&D Intensive Companies

Companies with high R&D spending would be hard-hit by amortization. Consider, as an example, a small company that has a high level of R&D spending, but the amount spent has remained constant over time. Assume the company has annual operating income of $150 million a year and that it has been spending $100 million annually on R&D for the past several years. If this company had always been required to amortize its R&D over five years in computing its regular corporate income taxes, then the company would have a deduction of $20 million from the previous year, and so on for preceding years. With additional deductions for depreciation and so on, the company might have a taxable income of $25 million and, under a 35 percent corporate tax rate, would be paying $8.8 million in taxes.[2]

If, instead, this company had currently deducted its R&D in all previous years, and now suddenly a minimum tax with an R&D amortization requirement is imposed, the company will experience a sharp increase in its tax burden. In the current year it can deduct only $20 million for its R&D spending. Assume that the company's other deductions remain unchanged under a minimum tax at $25 million. Its income subject to the minimum tax would rise from $25 to $105 million. At a 25 percent minimum tax rate, the company would be required to pay $26 million in taxes. Its tax burden has increased by almost 300 percent.

The foregoing tax penalty on R&D would be borne by all companies with fluctuating income and deductions that dip into the minimum tax range from time to time and would be overtaxed because suddenly they are required to amortize their R&D expenses. Assuming that a minimum tax would permit taxpayers to elect to amortize R&D for both regular and minimum tax purposes as a condition for removing R&D as a tax preference, the penalty would still be paid for four years by companies that are permanently subject to the minimum tax, although it would diminish after the first year and would disappear after the fourth year.

Ironically, the adverse impact of eliminating R&D expensing for minimum tax purposes would be even more severe for companies with growing R&D -- or precisely those firms that are engaging in the kind of activities that will increase our nation's productivity.

The amortized R&D deductions for companies with continually growing R&D budgets will never catch up to annual R&D spending. If the company in our previous example had been increasing its R&D budget by $10 million a year, then for purposes of the minimum tax, this company's taxable income in the fifth year is still $30 million higher than it would be with expensing, resulting in a $6 million penalty even in the fifth year. The penalty remains as long as the company's R&D budget keeps growing.

### The Penalty Effect of Amortization: Actual Data for Large R&D Spenders

The preceding examples were typical of small growing companies. Such companies would be the hardest hit. But even large established companies would be hard-hit if they spend heavily on R&D. This can be shown using actual company financial data. I looked at the top 30 spenders in 1984 and from these a sample of twenty-three was selected for analysis. Together these firms accounted for about 36 percent of the nation's R&D spending in that year.

Table 1 shows how the 23-company sample would be affected by a minimum tax had it been introduced in 1984, 1983, or 1982. Lines 1-3 show that the companies earned $29.9 billion in 1984, paid $7.1 billion in taxes and had an average tax rate of 24 percent. Lines 4-5 estimate

Table 1: First-Year Effects of 25 Percent Minimum Tax

23 of the Largest Corporate R&D Spenders

(billions of dollars or percent)

| | 1984 | 1983 | 1982 |
|---|---|---|---|
| (1) U.S. Financial Income | 29.9 | 25.8 | 19.4 |
| (2) Taxes Paid | 7.1 | 5.8 | 4.1 |
| (3) Sample Tax Rate | 24 | 23 | 21 |
| (4) Taxes Paid with Revisions (line (2) times 1.2) | 8.6 | 7.0 | 4.9 |
| (5) New Tax Rate | 29 | 27 | 25 |
| (6) Taxes Paid with 25 Percent Min. Tax with Amortization | 11.7 | 10.1 | 7.8 |
| (7) Tax Rate with Min. Tax | 39 | 39 | 40 |
| (8) Tax Boost from Min. Tax | 3.1 | 3.1 | 2.9 |
| (9) No. of Companies Subject to Min. Tax | 18 | 19 | 20 |

what tax would have been paid by these companies had the provisions in the Ways and Means plan been in force in each year, except for the minimum tax. As an approximation, I assumed that this would have raised each company's taxes by 20 percent, up to $8.6 billion in 1984, equal to 29 percent of income.

Lines 6-7 calculate how much tax the companies would have paid if a 25 percent minimum tax had been introduced in each of the three years, if the minimum tax required the amortization of R&D costs over 5 years. The tax bill in 1984 would have jumped to $11.7 billion, equal to 39 percent of financial income. As shown in lines 8 and 9, this minimum tax would have hit 18 out of the 23 companies and boosted their tax payments by $3.1 billion in 1984 -- a 36 percent increase.

The companies in the sample are not low tax payers. They include many of the companies most central to our industrial success, such as IBM, GM, Boeing, and Eastman Kodak.[3] The Ways and Means' plan would likely boost their taxes to 29 percent of income but 18 out of the 23 would still be subject to a minimum tax requiring amortization of R&D costs.

## Requiring Amortization Discourages R&D Spending

In order to assess the impact of the various proposed tax changes on R&D spending, I calculated how a company's expected rate of return from a successful R&D project would be affected by various alternative tax rules. If, for example, a particular tax provision raises the rate of return by 5 percent, then it is said to provide a 5 percent incentive to R&D spending. The results we found were as follows.

(a) Current law, including the R&D tax credit, provides a 6.9 percent incentive to R&D. The Ways and Means plan would cut the incentive effect of the credit by more than half.

(b) A company subject to a 25 minimum tax under which the R&D tax credit was disallowed, but R&D could be expensed, would find that the positive incentive to R&D in current law was entirely eliminated.

(c) If a company subject to the minimum tax were also required to amortize R&D costs over 5 years, then it would face a 4.6 percent disincentive to R&D spending.

(d) Using estimates from earlier studies, I estimate that the combined effect of weakening the tax credit and requiring amortization of R&D would have cut U.S. R&D spending by $2 to $5 billion in 1984.

## The Treatment of R&D in Reported Profits

A goal of the minimum tax is to ensure that all profitable companies pay their fair share of taxes. And although I am more concerned about fairness among people than among corporations, I understand the argument that the tax-paying public must maintain its belief in and support for the tax system. However, because companies are required by the SEC to deduct their R&D expenditures in the year in which they occur, they will never, as result of R&D spending, report higher profits to shareholders than they report for tax purposes. The press reports of highly profitable companies paying little or no tax are never due to the tax treatment of R&D costs.

Moreover, public opinion polls consistently show a public desire to encourage R&D. Taxpayers will have more confidence in a tax system that does this, not less.

## Expensing is Closer to True Economic Depreciation

Edwin Mansfield, a leading expert on innovation, has found that seven out of eight R&D projects fail. Since a failed project creates no asset of lasting value, it follows that expensing is the appropriate way of treating the great majority of R&D costs. In principle, companies might be required to amortize successful projects. But such an approach is infeasible because success or failure is not revealed for several years after the R&D expenditures are made.

Another approach that might be considered is to assume that successful and unsuccessful projects average out. This approach would put small companies at a major disadvantage. These companies may have only one or two substantial projects and cannot count on a percentage of successes.

Expensing R&D for tax purposes represents a slightly more favorable treatment than that implied by true economic depreciation.

But requiring all R&D expenses to be amortized over five years is much more unfavorable, and would be a move away from true depreciation.

## Conclusion

There is a clear economic case for government support for R&D. This case rests on the fact that the private market fails to provide an efficient signal to companies as to the amount of R&D spending to be made. When a company innovates, the benefits of this spill over onto consumers and other companies. Taxpayers are better off if they are willing to invest in industrial R&D.

Despite the convincing case for R&D support, the United States Congress has before it a number of proposals that would have the opposite effect. These proposals would deny expensing treatment for R&D for minimum tax purposes even though R&D expenditures currently can be expensed for regular tax accounting purposes and _must_ be expensed for financial accounting purposes. The amortization proposals would penalize a group of R&D-intensive corporations many of which are already paying a high effective rate of tax. The proposals would undermine the existing incentives to invest in R&D and would penalize rapidly growing companies that are developing the new technologies that will be the foundation of our industrial sector in the future.

The purpose of the minimum tax is to make the tax system fairer. But a major component of fairness for corporations is international fairness. U.S. companies are currently very hard-pressed by foreign competition. It is surely unfair to expect U.S. companies to amortize their R&D costs when virtually all of our major competitors not only allow expensing, but also provide direct incentives for R&D.

I urge you to maintain the support for R&D that exists in current law. In particular, proposals to require the amortization of R&D for a minimum tax should be rejected.

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[1] The views expressed in this statement are the sole responsibility of the author and do not represent those of the Brookings Institution, its officers, trustees, or other staff members.

[2] In most of the numerical examples presented it is assumed that the marginal corporate tax rate is lowered to 35 percent, as proposed by the Ways and Means Staff.

[3] The others are Johnson and Johnson, Motorola, 3M, Monsanto, Dupont, Lockheed, Exxon, Xerox, Honeywell, General Electric, Proctor and Gamble, Rockwell, Sperry, McDonnell Douglas, United Technologies, Merck, Lilly, Digital, Hewlett-Packard.

BEFORE THE SENATE COMMITTEE ON FINANCE

# WRITTEN SUBMISSION OF ALBERT E. MAY
ON BEHALF OF THE
COUNCIL OF AMERICAN-FLAG SHIP OPERATORS
AND
MATSON NAVIGATION COMPANY, INC.

on the

## Capital Construction Fund (CCF) Program
Authorized under Section 607 of the
Merchant Marine Act, 1936

October 9, 1985

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## WRITTEN SUBMISSION OF ALBERT E. MAY
## BEFORE THE SENATE COMMITTEE ON FINANCE

### Introduction

This statement is submitted by Albert E. May, Executive Vice President of the Council of American-Flag Ship Operators (CASO), on behalf of CASO and Matson Navigation Company, Inc., (Matson). CASO is an association whose member companies operate U.S.-flag liner vessels and are dedicated to preserving and expanding the U.S.-flag merchant marine. These companies represent the majority of U.S. flag-liner companies serving the foreign commerce of the United States. They own and operate a modern and diversified fleet of breakbulk, container, barge-carrying, and roll-on, roll-off vessels, all of which are available under various programs for use by the United States during times of military emergency. Matson is a domestic offshore shipping company with headquarters in San Francisco, California whose primary business is the ocean transportation of cargo between the United States Pacific Coast and Hawaii. CASO and Matson appreciate the opportunity to submit this statement opposing certain aspects of the Administration's tax proposal which will adversely affect the maritime industry.

We believe that four specific elements of the Administration's tax proposal will have an adverse impact on our industry. These include the (1) repeal of the Capital Construction Fund (CCF) Program; (2) extension of the depreciation period for vessels; (3) repeal of the Investment

Tax Credit (ITC); and (4) depreciation recapture. Adoption of these proposals would inevitably cripple the U.S. Merchant Marine because the maritime industry is inherently capital intensive and in direct competition with foreign-flag ships who almost without exception receive more favorable treatment than do U.S.-flag ships. Because you undoubtedly will hear from other capital intensive industries which will be hurt by the proposals regarding depreciation and the ITC, this statement will focus on one capital investment incentive unique to the maritime industry -- the CCF program.

We strongly oppose the President's proposal to repeal the CCF. The repeal's stated rationale -- that "a national security justification for subsidies of U.S. maritime construction is today unclear" -- is unfounded and contrary to every recent analysis of the crucial military role of the U.S. merchant marine. A strong U.S.-flag merchant marine is critical to national security and defense. The proposed CCF repeal also ignores the other essential national purposes served by the program, including the following: (1) the CCF program is a longstanding and significant part of the nation's maritime policy to maintain a strong U.S. merchant fleet; (2) the CCF program is crucial to achieving tax parity and competitiveness with foreign fleets. In addition, CCF repeal would illegally abrogate existing contracts between the U.S. government and fundholders. Finally, CCF repeal would yield little, if any, revenue for the U.S. Treasury. We believe that there is no policy justification for jeopardizing the future of the U.S.-flag merchant marine and the nation's security and defense needs for only a potentially nominal tax benefit.

## Description of the CCF Program

### 1. History and Purpose

The CCF program, set forth in Section 607 of the Merchant Marine Act, 1936 ("the Act"), encourages construction, reconstruction, and acquisition in the U.S. of vessels for the U.S.-flag foreign, non-contiguous domestic, Great Lakes, and fisheries fleets. U.S. citizen maritime and fisheries operators enter into binding contracts with the government which allow them to defer income tax on certain funds to be used for an approved shipbuilding program. The Treasury recoups the deferred tax through reduced depreciation deductions and higher taxes in later years because the tax basis of vessels purchased with CCF funds is reduced dollar for dollar to compensate for the tax deferral.

Congress enacted the CCF program in its current form in 1970 to revitalize the U.S. maritime and fisheries industries in several important respects: (1) by providing a measure of tax parity with foreign fleets; (2) by facilitating transportation between the continental U.S. and the noncontiguous states of Alaska and Hawaii, as well as Puerto Rico and the various U.S. possessions; (3) by helping to modernize the aging Great Lakes fleet; and (4) by enabling U.S. fishermen to compete more equitably with foreign fishing industries.

Since the current CCF program was established, the government has executed CCF contracts with some 125 maritime operators. These American entrepeneurs deposited about $4 billion in CCF funds to be used in building and rebuilding of the U.S. flag fleet -- an average of more than one million dollars every business day since 1970. The CCF program has facilitated the construction and reconstruction of hundreds of vessels in American shipyards for operation in the U.S. foreign, Great Lakes, and noncontiguous domestic trades.

### 2. Deposits into the CCF and Tax Deferral Treatment

Four kinds of funds may be deposited into the CCF:

- income from the operation of agreement vessels up to the amount of the party's total taxable income;
- unclaimed depreciation deductions of agreement vessels;
- net proceeds from the sale or other disposition of agreement vessels; and
- earnings from deposits in the CCF.

The fundholder's taxable income is reduced by the amount deposited from vessel operations. Funds deposited from the sale or other disposition of a vessel are not recognized for tax purposes. Earnings from amounts already in the CCF are not taxed, if redeposited.

The fundholder must deposit sufficient funds to fulfill the vessel producing policy of the fund and thus prevent obsolescence. But the fundholder may not deposit more than necessary to complete its program, thus insuring that no monies are deposited solely to avoid taxation. In addition, there are restrictions on investment of the assets in a CCF.

### 3. Withdrawals and Their Tax Treatment

The only withdrawals which are qualified are those for vessels to be used in the foreign, noncontiguous domestic, or Great Lakes trades. A qualified withdrawal is not taxed. However, the depreciable basis of the vessel is reduced to compensate for the tax deferral on deposits. In addition, these withdrawals must be used only for certain capital costs, must satisfy "Buy American" requirements, and cannot be made to related persons except upon approval.

Withdrawals for any other purpose are considered nonqualified. Significantly, fundholders must obtain permission from the Maritime Administrator prior to making nonqualified withdrawals. The Maritime Administrator will not permit such a withdrawal if the purposes for establishing the CCF will be undermined. Failure to obtain the needed permission could result in cancellation of the agreement and a denial of all future tax benefits. Nonqualified withdrawals are subject to taxation and the imposition of an interest penalty from the date of deposit, effectively negating the value of the tax deferral.

### 4. Proposal to Repeal the CCF Program

The President's Tax Proposal would repeal the CCF program by providing that no tax-free contributions to CCFs could be made after 1985, except for qualified agreement vessels that the taxpayer owned on January 1, 1986, or qualified agreement vessels on which the taxpayer had performed (or had caused to be performed) a substantial amount of construction or reconstruction before January 1, 1986. To the extent that fund assets exceeded amounts designated under the agreement to be used with respect to such qualified vessels, earnings on such excess attributable to the period after December 31, 1985, would be taxable. Any withdrawals from a fund on or after January 1, 1986, other than for qualified vessels, would be treated as nonqualified withdrawals, except that no interest charge would apply. Any amounts remaining in the CCF on January 1, 1996, would be treated as withdrawn at that time.

## The Role of the Merchant Marine in Furthering Security and Defense Objectives

### 1. Responses to the Proposal's Allegations

In its only justification for repealing the CCF program, the Administration's tax proposal states that "a national security justification for subsidies of U.S. maritime construction is today unclear." The allegation is unfounded and is contrary to every recent analysis of this subject by the agencies most knowledgeable about national defense needs. (See Appendix B for a compilation of recent analyses the crucial military role of the U.S. merchant marine.) The merchant marine performs a critical role in national defense in providing sealift, carrying out strategic requirements as needed, and continuing to carry the international and domestic commerce of the United States.

Treasury's statement that ships registered in Panama and Liberia and Honduras and owned by U.S. citizens would be available to the United States in an emergency and that U.S. allies would provide their fleets in any common emergency is unsupportable and unrealistic. The Department of Defense strongly disagrees with Treasury's conclusion. Indeed, Assistant Secretary of the Navy for Shipbuilding and Logistics Everett Pyatt recently criticized what he termed the tax proposal's "gross oversimplification of the role of the merchant marine." The Assistant Secretary further noted that "[t]he conclusion that foreign flag ships would be available to support U.S. operations is not supported by fact or agreement. In fact this rationale is in direct contradiction with the President's recent statement on the merchant marine." (See Appendix B for complete text of Assistant Secretary Pyatt's letter to the Treasury.)

The Congressional Budget Office ("CBO") has warned that the militarily useful merchant marine is shrinking to a point where it may not be adequate to support military operations at a scale of even the Korean or Vietnam conflicts. The CBO's 1984 report, U.S. Shipping and Shipbuilding: Trends and Policy Choices, stresses the vital link between the U.S. merchant marine and national defense:

> "Whatever may be the commercial disadvantages, the United States continues to have strong objectives to maintain a national fleet of merchant ships. Sealift, the carrying of people and materials overseas on ships, is a fundamental requirement of U.S. military strategy." (p. xviii)

### 2. The National Security Objectives

As a matter of day to day policy, the Department of Defense relies on the American owned, citizen-crewed vessels of the U.S. merchant marine to provide reliable and secure transportation of military cargo.

In wartime, the sealift capacity of the U.S.-flag merchant marine becomes even more vital. Nearly all U.S. allies are overseas and about one-fourth of U.S. land combat power is stationed overseas. U.S. support of its allies and its forces must be sustained by sealift. In addition, the remaining U.S. ground power stationed in the continental United States need to be transported to the combat areas. The Joint Chiefs of Staff have estimated that:

> In any major overseas deployment, sealift will deliver about 95% of all dry cargo and 99% of all petroleum products. Ships from the U.S. merchant marine represent the largest domestic source of sealift, making them an important strategic resource.

The U.S.-flag merchant marine may also be needed to carry out specific strategic requirements for which government-owned ships are not available.

### 3. The Limitations of Airlift

Airlift cannot meet these military needs. Airlift is planned for the rapid movement of troops and the fast delivery of small amounts of critical supplies and materials. But airlift is severely limited in terms of its ability to carry oversized cargo and in its overall carrying capacity. Moreover, airlift uses vast quantities of fuel. According to the Joint Chiefs of Staff, U.S airlift support of Israel during the Yom Kippur War required six tons of aviation fuel for every ton of military cargo delivered to Tel Aviv.

### 4. The Need for U.S.-Flag Ships

As Assistant Secretary Pyatt pointed out to the Treasury, the tax proposal's "gross oversimplification of the role of the Merchant Marine misses the point that the most useful ships for military purposes are under U.S.-flag while the flags of convenience. . . are used primarily to support the national economy rather than direct military support." Indeed, historical experience has shown that even U.S.-owned, foreign-registered vessels are not as dependable as U.S.-flag shipping in time of war. Wartime operations involve considerable hazards. Defense officials have recognized the risk in depending on vessels operating under the sovereign flag of an alien nation and manned by foreign crews for operations vital to a U.S. war effort. The United States, therefore, must maintain a critical mass of U.S.-flag vessels, owned and crewed by U.S. citizens, for available and dependable support for military operations.

### 5. Sealift is Best Provided By An Operational U.S.-Flag Fleet

An operational U.S.-flag fleet has advantages of reliability, cost-effectiveness, and readiness in comparison with a reserve or a foreign-flag fleet.

- An active vessel, unlike a reserve fleet, has an active, trained crew ready to serve immediately in an emergency. All U.S.-flag vessels are available for requisition in a national emergency, and all subsidized vessels must be enrolled in a sealift readiness program.
- Foreign-flag vessels manned by foreign crews raised reliability concerns at the start of the Vietnam conflict and during the 1973 Mideast crisis. U.S.-flag vessels and crews have, however, performed consistently.
- The government obtains sealift capability by assisting the financing and operation of merchant vessels, rather than being required to acquire and maintain the vessels solely at government expense.
- The government also avoids the substantial maintenance costs of reserve vessels, currently nearly $1 million per vessels per year.
- The reliability of the National Defense Reserve Fleet, which consists mostly of World War II Victory ships, is questionable.

A recent study by the National Advisory Committee on Oceans and Atmosphere (NACOA) supports the conclusion that the merchant fleet provides the best source of sealift. The report recommends that to decrease the nation's dependence on a government-owned and maintained Ready Reserve Force, the Navy and the Congress place greater emphasis on examining alternatives for increasing the number and the military usefulness of the operating U.S.-flag commercial fleet.

### 6. Future Needs

The most recent Department of Defense analyses have concluded that the U.S. merchant marine is the critical factor in meeting our essential sealift requirements in support of our basic military planning. As initiated by the Secretary of Defense, joint studies by the Departments of Defense and Transportation are underway to assure that the nation always maintains adequate sealift capacity.

The U.S.-flag merchant marine cannot be permitted to decline. It must be modernized and upgraded if the United States is to maintain the credibility of our foreign policy and a strong national defense. Repeal of the CCF program would jeopardize the availability of U.S.-flag ships to meet these overriding national security and defense objectives.

## CCF as a Cornerstone of Maritime Policy

Incentives for U.S. construction of vessels similar to those provided by the current CCF program have been a vital part of U.S. maritime policy since the early years of the Roosevelt Administration. As the Senate Report on the Merchant Marine Act of 1936 observed: "If the United States desires a merchant fleet to carry its foreign commerce, operate as a naval auxiliary and give employment to our labor, and if it desires to maintain the American wage scale in its shipyards and on its ships on the high seas, it is apparent that Government aid is required."

The Report continued: "If we would preserve our own freedom in the overseas trade, and are not willing to be bond slaves to the shipping interests of foreign nations, we must place the American owner of an American-built ship on a basis of competitive equality with these foreign ships. If this be done, what reason is there to believe that capital will not be invested in American-built ships?" (S. Rept. No. 1721)

Repeal of the CCF program, an integral part of long-standing merchant marine policy, would repudiate a cornerstone of U.S. maritime policy for nearly a half century, under the rubric of tax reform. The proposed repeal also ignores the counsel of Chairman Jones and Ranking Minority Member Lent of the Merchant Marine and Fisheries Committee that the CCF program is fundamentally a maritime program, not a tax program. The repeal of CCF would undermine the careful planning and millions of dollars of investment that U.S.-flag operators made in reliance on contracts with the United States government. As Chairman Jones and Representative Lent noted, repeal "would seriously undermine the entire framework of the nation's maritime policy."

The proposal also disregards the joint studies of sealift and shipyard mobilization, initiated by the Secretary of Defense, which are underway by DoD and DOT: as well as a Congressionally authorized Commission on Merchant Marine and Defense currently being formed by the President to assess the Nation's current sealift and shipyard capacity and its shortfalls. These studies have been initiated only recently, and it is premature to disrupt as important a maritime program as the CCF prior to their completion.

Repeal would eliminate one of just two remaining incentive programs for the modernization of the U.S. merchant fleet.

Especially in light of the recent changes in maritime programs, and the ongoing studies on the merchant marine, we believe it is premature to repeal CCF in the context of tax reform. We believe that the authorizing Committees with substantive jurisdiction and Congress carefully review and evaluate the CCF program in the context of overall U.S. maritime policy.

## CCF as Essential for Preserving International Competitiveness

Due to the global nature of international trade, American-flag vessels must compete head-on with foreign-flag vessels from countries that give their merchant marine substantial tax and other assistance for shipbuilding. (See Appendix C for a chart depicting some of these specific tax subsidies.) It is virtually impossible for U.S.-flag ships to be competitive without the CCF program.

The foreign competitors of U.S.-flag ships in the U.S. foreign trades are generally not subject to U.S. taxes or are structured to avoid paying U.S. taxes. In addition, many of these foreign operators receive favorable subsidies and tax benefits from their governments. Furthermore, the U.S. generally has imposed no current tax on the earnings of U.S.-owned foreign merchant ships because the tax laws encourage reinvestment in foreign assets.

Any increase in U.S. tax that would result from repeal of the CCF will adversely affect U.S.-flag ships without any adverse impact on their foreign competition. Indeed, CCF repeal will have the perverse effect of benefiting the competitive posture of the foreign-flag operators at the expense of U.S.-flag ships.

## Unconstitutional Abrogation of Outstanding Contracts

### 1. General Procedures and Requirements of CCF Contracts

As is further explained in Appendix D (Memorandum of Law entitled "Repeal of the CCF Would Abrogate Outstanding Contracts Between the United States and Existing Fundholders"), the CCF program is only available to companies who are willing to enter into binding contracts with the government obligating themselves to a shipbuilding program determined to be in the national security interest and that is subject to continual agency review, scrutiny, and administration. To apply for an agreement, merchant vessel operators must propose a program to MarAd. The Government will not enter into an agreement unless the proposed program is consistent with the policies and purposes of the Merchant Marine Act.

The Government is authorized to administer and enforce the CCF contract in a manner which will insure that the fund is properly established, that the assets in the fund are used to accomplish the program, and that the fundholder fully complies with all obligations and responsibilities. The government gains by encouraging the private sector to build ships in U.S. shipyards using private funds, in furtherance of national security and commercial goals. In exchange for these benefits and the many commitments by the fundholder, the Government agrees to provide the federal income tax benefits authorized by Section 607 of the Merchant Marine Act.

### 2. CCF Agreements are Binding Contracts

As a result of all these commitments, CCF agreements are mutually enforceable undertakings by which the government has assumed certain obligations and the fundholder has given valuable consideration. Although there are no precedents with respect to the CCF program, the Court of Claims has ruled that operating differential subsidy contracts and construction differential subsidy contracts, similarly established under the Merchant Marine Act, 1936, are not gratuities but ordinary commercial contracts, supported by consideration, which bind both the government and the private parties.

### 3. Reliance by Fundholders

Many companies have used the CCF program successfully for its intended purposes and have based major investment and trade route decisions in reliance on their contracts with the government. Abrogation of their contracts would cause substantial hardship to these companies by making them less competitive vis-a-vis foreign operators, or worse, forcing the curtailment of construction plans or certain operations.

### 4. Contractual Restrictions on the Abrogation of Contracts

Contract rights are a form of property whether the obligor is a private individual, a municipality, a state, or the United States. Under the Taking Clause of the Fifth Amendment, the federal government may "take" or abrogate its contracts only for a public purpose and upon payment of just compensation. The Supreme Court has held that a law which renders contracts invalid, releases or extinguishes them, or derogates substantial contractual rights implicates the Taking Clause. Under certain circumstances, including instances where the government is a party to a contract, the government's taxing power may not permit it to abrogate its contractual obligations (See Appendix D). Contractual limitations on the taxing power appear particularly strong where the taxing power appear particularly strong where the taxing power is not being exercise to raise revenue but merely in an attempt to be "revenue neutral."

### 5. Just Compensation

Even if Congressional authority exists to abrogate CCF contracts in exercise of the taxing power, which is far from clear, the Taking Clause of the Fifth Amendment requires that just compensation be provided to fundholders whose property is taken. The Supreme Court recently has held that "just compensation" under the Taking Clause is measured by market value at the time of the taking, except in cases where it is impossible to determine market value or where application of this standard would be manifestly unfair to the owner.

The tax benefits received by a CCF fundholder in return for his commitments and obligations under the program have a substantial value. If Congress were to abrogate existing CCF contracts and require fundholders to withdraw any or all monies, just compensation for the full monetary value of the contract would be required.

## Revenue Impacts

According to the President's proposal, repeal of the CCF program will not have a measurable revenue impact for fiscal year (FY) 1986. In subsequent years, the revenue impact will be *de minimus*. Moreover, if the revenue effects are properly calculated to account for the recapture of deferred taxes through a reduction of the basis of the acquired vessel, as has been done in recent studies, the potential revenue gains are seen to be only about one-half of the already low Treasury estimates.

A recent study of the five-year revenue effects of CCF repeal by Lawrence B. Pripeton, a certified public accountant, is attached as Appendix E. The study estimates the likely magnitude of future deposits, calculated on both an historical average basis and on a projection of the trend of past deposits. For comparison purposes, separate projections are set forth both including and excluding an unusual, large, one-time deposit by Sea-Land in 1982-83. In addition, the deferral benefits are calculated on the basis of both the 33% corporate rate provided in the President's proposal and the 46% rate of current law.

The revenue loss estimates for the five year period from 1986-1990 range from $177 million to $211 million dollars. These revenue estimates use the accurate future deposit projections which exclude the distorting Sea-Land transaction, and are based on the tax rates which would be in effect were the President's proposal adopted. The estimates are roughly half the Treasury and Joint Committee estimates of $400 million. Moreover, even the use of less favorable (and less accurate) assumptions as to future deposits and tax rates yields estimates considerably lower than the Treasury estimates. A recent study by the Argent Group, Ltd. confirms this analysis.

The Joint Committee has acknowledged that its methodology tends to overstate the cost to the government of CCF use. The Joint Committee measures as a revenue loss the amount of the tax deferral in the year of the CCF deposit and credits back in future years the additional tax recouped through depreciable basis reductions. However, much of the loss would be paid back to the Treasury after the five-year period considered in the Committee estimates. This payback is not fully included in the Joint Committee's calculations. The more accurate approach to calculating the five-year revenue loss views the tax deferral as an interest-free loan, and calculates the cost to the government of such a loan over the period under consideration.

Elimination of the CCF program actually could result in a revenue loss to the Federal Treasury. Companies which have relied on the availability of CCF funds in making investment and operations decisions may have to cease operations because they cannot compete with foreign competitors, who do not pay any U.S. taxes. CCF repeal would encourage U.S. operators to place certain foreign shipping activities into foreign subsidiaries. Under Subpart F of the IRC, they would be granted a tax deferral as long as they continued to reinvest their earnings in foreign shipping assets.

Finally, for some fundholders, CCF repeal will create significant difficulty in meeting Title XI debt obligations and trigger defaults which would require MarAd to borrow from the Treasury. The CCF program is a critical source of funds for meeting Title XI Reserve Fund requirements as well as vessel financing payments. Elimination of CCF would make it extremely difficult, if not impossible, for many operators to find an alternative source of funds to meet the Reserve Fund requirement. Failure to do so would put these vessel owners in default under their Title XI financing agreements. Similarly, the enormous adverse effect on cash-flow caused by elimination of the CCF will create significant difficulty in meeting the Title XI debt obligations, also increasing the likelihood of defaults. Since the Title XI Revolving Fund has recently been depleted, these defaults would require MarAd to borrow from Treasury to pay off the bonds guaranteed under Title XI. More than $7 billion in obligation guarantees is outstanding under the Title XI program. A series of defaults, or even a single default triggered by the repeal of CCF, could easily cost the Treasury far more than it will gain in enhanced revenue from CCF repeal.

The cost-benefit ratio of the disruption to maritime policy to the revenue gain is out of proportion in terms of any rational approach to taxation.

## Conclusion

In closing, we wish to re-emphasize our concerns not only about the CCF program but about the affect of the Administration's tax proposal, as a whole, on the maritime industry. These changes in the tax code should not be enacted without consideration of our nation's broader maritime objectives. Congress must not forget the crucial role which the U.S.-flag fleet has played, and must continue to play, in our nation's defense and economy. The need to preserve a strong and healthy U.S.-flag merchant marine is compelling. We believe that there is no policy justification for jeopardizing the future of the U.S.-flag merchant marine and our national defense and security for a nominal tax benefit.

Thank you for providing us this opportunity to state our views.

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WRITTEN STATEMENT

Ira H. Shapiro
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Hearings Before the Senate Committee on Finance
U.S. Senate
October 9, 1985
on the
Corporate Minimum Tax

Mr. Chairman and Members of the Committee, I am pleased to provide our analysis to the Committee on the proposed changes to the corporate minimum tax now before the Congress, as contained in the President's tax reform plan and the House Ways & Means Committee staff option.

We selected this issue for purposes of our analysis and testimony before the Congress because we see the corporate minimum tax as a provision that can have significant effects on corporations and yet is in danger of receiving insufficient attention when the focus of the debate is on the larger questions of tax reform. Thus, we hope that our analysis of the issues involved in these proposals for a corporate alternative minimum tax (AMT) will assist the Committee in addressing this area in a more comprehensive and deliberative manner at the appropriate time.

We are aware that the proper place of the minimum tax in the context of comprehensive tax reform is debatable. Indeed, the minimum tax has been viewed as a nemesis by some and as a savior by others during the course of the tax reform debate so far this year. Yet experience dictates that whatever tax reform is accomplished in this Congress is unlikely to be of such scope that the Congress will determine a minimum tax is not needed to supplement the regular corporate tax.

It is unfortunate to have to address this concern because, as a policy matter, a minimum tax is an admission of failure in the design of the tax system as a whole. It says that we have provided incentives in the tax system to encourage certain actions, but we become alarmed if these incentives are used too much. It's not simply a rhetorical question to wonder why we should be offended when companies have used legislated tax incentives to properly reduce their corporate tax liability. Yet when profitable companies are "too successful" in accomplishing this end by use of so-called tax preferences, that result becomes politically unacceptable.

Arguably, if "excessive" use of certain preferences is a concern, a better approach would be to limit the individual incentive. Then Congress could appropriately debate, in the context of the provision at issue, what maximum use should be permitted. Instead, the response has been, at least since 1969, to institute or revise the minimum tax. It has become, indeed, a predictable political response to the "tax fairness" issue.

Despite these political realities, it's important to note that a minimum tax should be, by nature and design, a limited response to the perceived problem. A minimum tax should not be used to raise significant amounts of revenue, and it probably cannot be designed to do so and remain a true minimum tax. Further, a minimum tax is unlikely to affect the fundamental fairness of the tax system. Given its uneven effects and often unpredictable interaction with the regular tax, it is not possible to systematically achieve better tax neutrality or tax equity, vertical or horizontal, through a minimum tax. Probably the best it can achieve is some assurance that all profitable companies (and individuals with some level of positive income) will pay a modicum of tax.

It will serve the Committee well to keep the rather limited objectives of a minimum tax in mind in its deliberations on the issue. Expecting it to accomplish too much would be a serious error. On the other hand, if a minimum tax could be devised that would appropriately address the perceived policy and political needs that remain after more basic decisions are made on the larger issues of tax reform, such a minimum tax might add importantly needed stability to the tax system as a whole.

We are operating from a basic premise that, whatever else is accomplished in tax reform, what is most needed is greater certainty and stability in the tax system. Since 1980, the Congress has enacted three major tax acts which have added in excess of 1,000 pages of statutory changes to the tax Code and another 300 regulations projects. The inventory of regulations projects is now in the range of 450. At the end of 1980, this inventory level was just over 200.

I cannot overemphasize the uncertainty and attendant costs that this state of affairs imposes on the business community today. This degree of change adds uncertainty at two levels -- first, the change itself and, secondly, the absence of detailed rules needed to implement the change. It has become very difficult to do adequate business planning in the current tax environment.

To the extent that annual tax changes of a structural nature are now stimulated because a few taxpayers have income but pay no tax, solving that problem is worth whatever effort it takes. In our view, the best justification for "tax reform," as well as for spending adequate time now on the minimum tax, is that the end result may mean less change and more certainty in the tax system as a whole. The goal should be to get it right and leave it alone.

What follows is our analysis of the present and proposed corporate minimum taxes, beginning with a background discussion which we believe will assist in putting the issues into context. We then proceed to discuss some of the more crucial questions of design that we have identified in the course of our study.

## Add-On vs. Alternative Tax

Since 1969, the corporate minimum tax has been an add-on tax; that is, the minimum tax has been paid in addition to the regular corporate tax after credits, at a rate of 15% on identified tax preference amounts. The preference items remained fairly static from 1969 until 1982 when TEFRA added additional preferences to both the individual and corporate minimum taxes. It should be noted that in the Revenue Act of 1978, individual taxpayers were subjected to an alternative minimum tax in addition to an add-on minimum tax. In 1982, the individual minimum tax was changed by repealing the add-on minimum tax, and a revised alternative minimum tax was instituted.

The corporate add-on minimum tax was initially enacted to ensure that "all taxpayers are required to pay significant amounts of tax on their economic income," according to the General Explanation of the TRA of 1969. The legislative history indicates that the primary concern was that many corporations did not pay tax on a substantial part of their economic income. In recent years it has become better understood that the add-on minimum tax really acts to increase taxes on companies already paying high effective rates of tax. This difficulty is acknowledged in the "Reasons for Change" section of the President's proposal for an AMT. It states also that an alternative minimum tax, "imposed only to the extent a taxpayer's regular effective rate of tax falls below a minimum acceptable level," would better achieve the purposes of a minimum tax. We agree that an alternative tax is a better approach. However, we have identified some issues of design discussed below that are critical to the fair operation of a corporate alternative minimum tax, particularly one levied at a relatively high tax rate.

## Revenue Considerations

It's very important in thinking about the proper design and application of a minimum tax, to keep revenue considerations in the proper perspective. In the last decade, the add-on minimum tax has contributed from 1/2 of 1% to nearly 1% of corporate receipts. Clearly it has not been a big contributor to corporate revenues. The President's proposed AMT is estimated by the

Department of Treasury to increase corporate receipts from the minimum tax by $700 million annually, rising to $800 million in additional revenue by 1990, for a total of **$2.8 billion** over the period. Given the broader corporate tax base, it appears that the minimum tax would continue to be in the range of 1% of corporate receipts. In contrast, the option before the Ways & Means Committee would increase corporate tax burdens by **$13.8 billion** over the period.

This relationship provides the basis for my statement earlier that a corporate minimum tax probably cannot raise significant amounts of revenue unless it is levied at a rate close to that of the regular tax. It's questionable whether the tax proposed by Ways & Means is a minimum tax at all; given its revenue implications, its breadth of application and high tax rate, it will operate more like a separate, parallel tax. Such an AMT could not only significantly affect the tax liability of a specific company or industry, it will also require all companies to do some greater level of business planning with the minimum tax in mind. As such, it will add measurable complexity to the corporate tax system.

## Application to Industries

Our analysis of aggregate statistics indicates that the present minimum tax is paid primarily by a few industries and by larger companies. Included as an Appendix are analytical tables we've prepared, based on the latest statistics available from the Internal Revenue Service on 1982 corporate tax returns. Sufficient detail is not available to us to analyze all aspects that the Committee may wish to look at, but the aggregate statistics do provide some interesting insights on the application of the tax today.

For example, 44% of the minimum tax is paid by manufacturing companies and 74% of the tax is paid by companies with assets of $250 million or more. This result is dictated by the fact that the preference items having universal application -- depreciation on real property and capital gains -- are concentrated in the manufacturing industry, with significant shares also in the industry segments of transportation, public utilities and wholesale and retail trade. Approximately 50% of present preference items consists of capital gains, while 13% represents depreciation. In the case of the add-on minimum tax, the investment tax credit (ITC) is also a factor because the add-on minimum tax in essence partially negates the use of credits against the regular tax. ITCs also are concentrated in the manufacturing, transportation and public utilities industries.

Under the AMT proposal before the Committee on Ways and Means, the tax would apply much more broadly, given its higher tax rate and expanded view of preference items. Under the structure proposed, the AMT would generally apply whenever tax preferences exceed 40-50% of taxable income. Many companies may be subjected to AMT for the first time -- financial firms affected by the tax exempt interest preference, contractors using the completed contract method, and high technology companies with research and development expenditures and sometimes using the completed contract method as well.

The President's proposed AMT would generally affect companies in a fashion more similar to present law. Given its structure and rate, the AMT would apply to companies when preferences are roughly 65% of taxable income. The most significant change in application may result from the new preference proposed for net interest expense up to the amount of accelerated depreciation on personal property placed in service after 1985. As the Appendix tables indicate, only the category "finance, insurance, and real estate" shows net interest income. In aggregate, all other industries have net interest expense. Also of interest is the pattern of net interest expense by asset size. Smaller companies tend to have net interest expense, with the largest shares reflected in companies with assets in the range of $500,000 to $5 million. This pattern may indicate that some shift in application of the AMT would occur, compared to the present add-on minimum tax, from larger to smaller companies as a result of this new preference.

## Tax Base & Rate

The AMT option before the Ways and Means Committee forces the Congress to carefully consider the proper tax base for a corporate minimum tax, and it will require some mechanism to better coordinate that tax with the regular tax system. At the outset it's good to keep in mind that this would be the first corporate alternative minimum tax. Thus we're setting out to define the concept of economic income for corporations and to determine the appropriate minimum rate of tax on that income. The right answers to these two basic questions are not self-evident, but rather will require the Committee's careful consideration.

Indeed there is great variability in the concepts used by different researchers to measure economic income, while another set of rules is suggested by the tax rules for E&P purposes, and yet another by generally accepted accounting principles. A good example is the variability in permitted depreciation of assets -- does a building last 30, 35 or 40 years? Or take the treatment of R&D expenses which **must** be written off currently for accounting purposes and **may** be deducted for tax purposes today. Yet these costs would be treated as a tax preference under the Ways and Means minimum tax proposal. What's the right treatment? The answer will govern **whether** a company has economic income as well as determine **how much** income should be subject to minimum tax. These questions are not esoteric ones, to be resolved later as refinements are made, but are basic to the application of such a tax to corporations.

The importance of this conceptual difficulty is heightened because the current proposals would not just tax income that is presently excluded for regular tax purposes, but would also accelerate the time at which tax is paid in many instances. The treatment accorded R&D expenses, accelerated depreciation, and receipts from long-term contracts, illustrates just a few of the significant cases of such acceleration.

The inclusion of R&D expenses as a tax preference in the House Ways and Means Committee proposal and, thus, an additional item of economic income, is highly questionable. As noted previously, such costs must be expensed under generally accepted accounting principles. A particularly onerous result would be a substantial increase in the cost of venture capital for high technology start-up companies that have neither income for financial reporting or tax purposes nor positive cash flow. Furthermore, it may cause large, established high technology companies, already paying a relatively high effective tax rate, to pay substantially higher taxes. These companies may also find themselves in a permanent AMT position and not be able to benefit from the AMT credit carryover provision.

The R&D preference would amount to a penalty on R&D activities that seems unwarranted as part of the tax reform objective.

Because corporations experience greater variability in earnings generally, these differences in treatment of certain income and expense items could result in a corporation paying tax on the same income twice -- once under the minimum tax and later under the regular tax. Alternatively, some companies may be on the AMT permanently, and thus denied the benefit of any incentive credits; a good example of this dilemma is presented by high technology companies as a result of having permanently high R&D expenses. Further, companies with variable earning patterns that cause them to shift back and forth between the minimum and regular tax could conceivably end up paying more tax over time than companies that stay under one tax or the other.

And what about the proper minimum tax rate? In a system where the minimum tax is very broad and imposed at a rate close to that of the regular tax, the concept of a **maximum tax rate** may be warranted. We have identified some situations in which a company that has paid regular tax for some years at normal effective tax rates could be adversely and unfairly affected by the AMT in a year or years in which the company experiences a reduction in earnings or even a temporary loss, or alternatively, in a year when preference items are atypically high. In our experience, these situations are not uncommon. Because each tax year is considered on its own and a taxpayer can flip back and forth between the AMT and regular tax, it would be possible for companies to pay tax, on average, well in excess of the statutory rate of 33% or 35% of taxable income over a period of several years. This result would also hold true for companies permanently thrust onto the AMT.

The following Table I contains an example of this problem computed on the basis of 1982 SOI statistics for manufacturing companies having net income. Thus, in a sense we have an "average" manufacturing company reflected in these figures. As illustrated, when income is reduced by 10%, the company that had paid regular tax in the previous year now becomes subject to the AMT. If income declines 20%, the company experiences a loss but would still be subject to an alternative minimum tax. Table 2 illustrates the average effective tax rates for the two years, using both taxable income and economic income. As noted, effective tax rates based on taxable income can exceed 40%. These computations are based on the House Ways and Means Committee proposal but the results are similar using the President's proposal as well.

In this example we have assumed that preferences represent about 40% of taxable income and about 2% of total deductions in the average year. One reason for the results illustrated here is another key assumption -- that deductions will not decline significantly when income falls off. This parallels actual experience for most companies. Companies cannot reduce fixed costs as quickly as their sales decline. Further, most preference items are items of deduction, not items of income.

The average effective tax rate computations are oversimplified but still illustrative of the potential problem. The problem is best understood by thinking of the alternative minimum tax as a second tax system, one that imposes tax at 20% or 25% on "economic income," paralleling the regular tax of 33% to 35% on taxable income. In one year a company may pay the AMT, in the next the regular tax and so forth. Over a few years it would be possible for a company to end up paying tax well in excess of 33% on taxable income. As the example also illustrates, a company can be subject to the AMT in years when taxable income is negative.

Table 1

AVERAGE MANUFACTURING COMPANY*

| | Average Year | Decline In Sales | |
|---|---|---|---|
| | | 10% | 20% |
| Sales | $1,839,000 | | |
| Cost of Sales | 1,267,000 | | |
| Gross Profit | $ 572,000 | $515,000 | $458,000 |
| Other Income | 106,000 | | |
| Depreciation Deduction | (67,000) | | |
| Interest Expense | (55,000) | | |
| Other Deductions | (458,000) | | |
| Net Deductions | (474,000) | (474,000) | (474,000) |
| Taxable Income | $ 98,000 | 41,000 | (16,000) |
| Regular Tax @ 35%** | $ 34,300 | 14,350 | -0- |
| Assumed Preferences | 39,000 | 39,000 | 39,000 |
| Add: Taxable Income (Loss) | 98,000 | 41,000 | (16,000) |
| Alt. Min. Taxable Income | 137,000 | 80,000 | 23,000 |
| AMT @ 25%** | $ 34,250 | $ 20,000 | $ 5,750 |
| Tax Payable | $ 34,300 | $ 20,000 | $ 5,750 |
| Increase in Tax Due to AMT | -0- | $ 5,650 | $ 5,750 |

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*Based on 1982 SOI for all manufacturing companies with net income.

**These computations disregard the lower level exemptions.

Table 2

TWO-YEAR AVERAGE EFFECTIVE TAX RATES

| Assumptions | Average Tax Rate Based On Taxable Income | Average Tax Rate Based On "Economic" Income* |
|---|---|---|
| No Decline in Income (Average Year) | 35% | 25% |
| 10% Decline (Average Year and Year of 10% Decline) | 39%** | 25% |
| 20% Decline (Average Year and Year of 20% Decline) | 42%** | 25% |

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*Computed on taxable income plus preference income as defined in President's proposal.

**Before utilization of alternative minimum tax credit carryover.

## Need for Averaging Device

These design issues lead us to urge the adoption of an income averaging feature or a tax benefit rule to smooth out the uneven effects and evident unfairness the AMT could have on companies over time. On this longer time horizon, the treatment accorded net operating losses is similarly important if we are to avoid imposing a minimum tax on a company that has had economic losses in preceding years.

Such adjustments are especially crucial if the minimum tax is imposed at the relatively high rate of 25%. Under such circumstances the minimum tax would in essence become a separate, parallel tax system, undeniably adding complexity and requiring tax planning for many companies.

The House Ways and Means Committee proposal has addressed this problem by allowing the AMT tax paid in one year to be used as a credit against regular tax paid in later years. It also allows taxpayers to elect "normalized" treatment of tax preference items to avoid the AMT. These are desirable features but even more coordination may be necessary. For example, for how many years can AMT credits be carried over? Can the AMT credit be used against regular tax with no limit? Isn't it necessary to specify that a company will not be subject to AMT for the current year if its regular tax liability is reduced only because of AMT credits from an earlier year? Further, the credit mechanism will not suffice for those companies that end up permanently on the minimum tax.

Finally, coordination between AMT credits and any ITC or other incentive carryover credits will be needed. For example, if a company has carryovers of both into a year where payment of regular tax is due, which credit is used first and which is carried over? If AMT is used first, the danger would arise that the ITCs could expire.

These issues suggest that if a credit mechanism is used to coordinate the two tax systems, the AMT credit should have unlimited life, should be used after incentive credits, and should not be subjected to any dollar or percentage of tax limit. Companies that will be on the minimum tax more or less permanently can only be helped by electing normalized treatment of their preference items. They must hope that Congress takes a judicious approach to the definition of economic income.

## Use of Tax Credits

Congressional policy on the use of various tax credits against the minimum tax has not been consistent over time. In general the alternative minimum tax for individuals has not allowed credits other than foreign tax credits and refundable credits. However, in 1980 Congress reviewed these issues and was concerned that, as a result of this policy on tax credits, taxpayers were not able to take advantage of the credits otherwise provided even when they had no tax preferences. This result occurs when the alternative tax is paid because it's higher than the regular tax reduced by tax credits alone, with no involvement of tax preferences. In this situation, the credit has provided no benefit to the taxpayer (see discussion in Tax Court case Huntsberry v. Commissioner 83TC742 (1984)).

Thus, Congress acted in 1980 to change this policy. For a limited period of time the law permitted the individual AMT to be reduced by credits attributable to the taxpayer's conduct of an active trade or business, including the ITC and the targeted jobs credit.* In 1982 when the AMT for individuals was revised again, the policy was changed. No credits are now allowed except the foreign tax credit and refundable credits.

In the present context, decisions must be made about the use of any tax credits retained under the reformed tax system, such as the R&D and rehabilitation tax credits and about investment tax credits carried over from 1985 and earlier years. If credits cannot be used against the AMT, their incentive value is reduced and in some years negated.

Further, if taxpayers are not allowed to use their ITC carryovers against the AMT, particularly unwarranted effects may result. Some taxpayers may be prevented for several years from using some of their credits, a delay which devalues those credits significantly. Such a denial would have the effect of retroactively increasing the tax, and reducing the yield, on assets purchased in the past. It should also be noted, in terms of the potential effect of this provision, that ITC carryovers are currently concentrated in manufacturing (85%); finance, insurance and real estate (12%); and wholesale/retail trade (8%).

If the Committee feels some limit is necessary, we would suggest that the overall limit on credits as a percent of tax liability also be applied to the minimum tax. As discussed above, ordering rules are also needed to coordinate the interaction of AMT credit carryovers with incentive credits.

## Treatment of Net Operating Losses

The President's proposal appears to contemplate that net operating loss carryovers would be permitted to offset the AMT in the future but that those operating loss carryovers would be reduced by amounts attributable to preference items. Under present law, NOLs can be carried back for three years and forward for 15. Under the individual AMT, NOLs are computed and tracked separately for purposes of the regular tax and the AMT. In essence, NOLs reduced for preferences can be used to offset the minimum tax. This is appropriate for the corporate AMT also, in order to avoid the risk of requiring a tax payment by a company that is recovering from a real loss situation, an inappropriate event and one we believe should not be intended.

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*H.R. 4155 passed Congress December 31, 1980 (P.L. 96-603) and applied to tax years beginning after December 31, 1979.

The House Ways and Means Committee proposal also seems to intend this treatment for new NOLs but the option contains an inappropriate rule having retroactive effect for NOLs coming into the new system as a transition rule. The Ways and Means option would retroactively reduce present NOLs which arose during 1983 through 1985. There is no apparent rationale for such an approach. We would urge the Committee to reject it and instead to follow the same rules that were used in 1982 which allowed full NOLs from pre-AMT years to be used to offset alternative minimum tax in subsequent years. In other words, net operating losses from 1985 and earlier years should not be reduced by "preference" amounts in applying these losses in 1986 and subsequent years. To do so would be tantamount to denying the tax benefit from preferences that the law permitted at the time but which could not be fully utilized due to insufficient income.

## Preference for Net Interest Expense

The President's proposed AMT would add as a preference item 25% of net interest expense, up to the amount of accelerated depreciation taken on personal property placed in service after 1985. Accelerated depreciation is measured by comparing CCRS amounts to those deductions that would have been allowable under Treasury's initially proposed system of indexed depreciation (RCRS, November, 1984). Interest expense is net of interest income.

The explanation of the President's proposals indicates that this preference item is included in order to compensate for the incentive feature of accelerated depreciation on personal property, which is heightened even further when the asset is debt-financed. The explanation also notes that the full deductibility of interest without adjustment for inflation, results in a significant mismeasurement of income that is more serious when the investment itself receives preferential treatment. Thus, the proposal attempts to ensure that the minimum tax applies "to corporations that substantially reduce their regular tax liabilities through such debt-financed investments."

The inclusion of 25% of net interest expense as an item of tax preference is designed to treat the taxpayer's first investments in CCRS personal properties as financed by debt. Further, the 25% fraction is intended to identify "on a conservative basis" the portion of interest representing an inflation premium, rather than a cost of borrowing money.

We question both the thesis and the mechanics of this preference, and urge the Committee to consider it carefully. We note the House Ways and Means Committee option wisely does not contain this item as a preference and instead has broadened the preference for accelerated depreciation generally.

The Treasury Department's proposals last fall called for indexing interest income and expense for inflation, across-the-board. This provision was not included in the President's proposals. We urge the Committee to consider whether it's appropriate to bring indexing of interest into play in one narrow area, such as the alternative minimum tax for corporations.

There are many good arguments for the initial Treasury proposals regarding indexing of interest, despite the problems therein which presumably caused the idea to be eliminated on the second round. But indexing interest across-the-board was expected to have positive effects on the economy, and taxpayers with net interest income would also experience positive tax results. In contrast, the present proposal would apply interest indexing only in situations when it is to the taxpayer's disadvantage, i.e., as a net debtor. As such, the proposed preference item does not seem to us to be either equitable or well justified on policy grounds. If Treasury's concern more basically is the degree of acceleration of depreciation on certain classes of personal property, it might be more appropriate to deal with that concern directly.

In terms of mechanics, the proposed preference has many flaws. It applies to all interest expense, regardless of when incurred. There is no attempt to match the interest expense being taxed as a preference with the property being depreciated under CCRS. Indeed the debt could be quite old, could be on real property, or could reflect little inflation premium, and it would still be included as interest expense in the AMT computation. This treatment amounts to an additional tax on an investment decision made in earlier years, retroactively reducing the return on those investments. It is certainly not obvious why the interest expense in the formula should not be limited to interest on debt incurred after 1985.

In addition, interest expense can be offset only against interest income in determining whether the preference applies. This creates a bias toward investment in interest-bearing instruments as opposed to equity investments. If this proposal is retained, consideration should certainly be given to expanding the offset to other passive income, such as dividends and rents.

Finally, the Committee should consider, in greater detail than we have been able to do, how this preference would affect the application of the AMT to various types of companies, based on the depreciation system adopted. Because the greatest degree of acceleration is provided in CCRS asset classes 1, 2 and 3, companies having a large portion of such assets and net interest expense could bear the greater portion of the proposed AMT. (These classes include autos, trucks, buses, computers, office equipment, aircraft and construction equipment.) It may also hit those industries presently having financial trouble, as a result of international competition or otherwise, that have low operating income (in relation to preference income) and are unable to obtain equity financing.

It would also appear to us that some questionable biases would be instituted with this preference item. For example, it may create a bias towards leasing personal property rather than purchasing property after 1985. Clearly, highly leveraged companies and newer ventures which tend to be debt-financed to a greater degree, would be disadvantaged. The 1982 Statistics of Income indicate that smaller companies may bear a higher proportion of the AMT than under the present system. It would also seem to have an adverse affect on leasing companies who are net borrowers using debt financing. On the other hand, companies having high amounts of interest income would be unaffected.

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This concludes my prepared statement. To summarize, we would urge the Committee to consider in its deliberations on this issue the limited objectives that a minimum tax should serve in the tax system. We would also caution that its design must be studied carefully. Because of complex interactions with the regular tax structure, it is all too easy to develop a minimum tax that has unintended consequences on taxpayer behavior, is unduly complicated, or works against other policy goals that Congress has established. We have raised some questions of design and application of the House Ways and Means Committee option and the President's proposal that we hope will assist the Committee in its further consideration of a corporate AMT. Most importantly, the Committee should try to resist pressure to overreact and by so doing to develop a corporate minimum tax that applies too broadly, to too many taxpayers, at too high a rate of tax. Such a result would add unwarranted complexity and unfairness to the system, rather than improving it.

MINIMUM TAX ANALYSIS

1982 ACTIVE COMPANIES WITH & WITHOUT NET INCOME

BASED ON INDUSTRY
(in millions)

| | ALL INDUSTRIAL DIVISIONS | AGRICULTURE, FORESTRY, & FISHING | MINING | CONSTRUCTION | MANUFACTURING | TRANSPORTATION & PUBLIC UTILITIES | WHOLESALE & RETAIL TRADE | FINANCE, INSURANCE, AND REAL ESTATE | SERVICES |
|---|---|---|---|---|---|---|---|---|---|
| TAX ON PREFERENCE ITEMS: | | | | | | | | | |
| AMOUNT | 478 | 1 | 81 | 8 | 210 | 47 | 39 | 79 | 13 |
| PER CENT | 100% | 0% | 17% | 2% | 44% | 10% | 8% | 17% | 3% |
| REGULAR AND CAPITAL GAINS TAX: | | | | | | | | | |
| AMOUNT | 84,990 | 490 | 3,203 | 2,070 | 45,006 | 11,356 | 11,372 | 7,607 | 3,886 |
| PER CENT | 100% | 1% | 4% | 2% | 53% | 13% | 13% | 9% | 5% |
| INVESTMENT CREDIT INFORMATION: | | | | | | | | | |
| CREDIT GENERATED | 25,084 | 217 | 895 | 492 | 10,711 | 7,320 | 2,295 | 1,572 | 1,582 |
| CREDIT ALLOWED | 17,296 | 118 | 426 | 323 | 6,714 | 6,287 | 1,575 | 812 | 1,041 |
| CREDIT CARRYOVER | 7,788 | 99 | 469 | 169 | 3,997 | 1,033 | 720 | 760 | 541 |
| PERCENT | 100% | 1% | 6% | 2% | 51% | 13% | 9% | 10% | 7% |
| ANALYSIS OF PROPOSED NET INTEREST PREFERENCE: | | | | | | | | | |
| INTEREST DEDUCTIONS | 515,009 | 3,049 | 7,624 | 5,455 | 79,388 | 36,839 | 30,429 | 340,960 | 11,265 |
| INTEREST INCOME | 515,608 | 753 | 2,671 | 3,090 | 37,630 | 9,103 | 14,278 | 443,020 | 5,063 |
| NET INTEREST EXPENSE | (599) | 2,296 | 4,953 | 2,365 | 41,758 | 27,736 | 16,151 | (102,060) | 6,202 |
| TOTAL DEPRECIATION | 213,119 | 2,092 | 7,307 | 6,033 | 89,002 | 49,930 | 24,949 | 15,886 | 17,118 |
| PERCENT | 100% | 1% | 3% | 3% | 42% | 23% | 12% | 7% | 8% |
| LONG TERM CAPITAL GAIN INFORMATION: | | | | | | | | | |
| AMOUNT TAXED AT 28% RATE | 12,023 | 108 | 320 | 203 | 5,249 | 1,798 | 1,006 | 2,778 | 559 |
| PERCENT | 100% | 1% | 3% | 2% | 44% | 15% | 8% | 23% | 5% |

MINIMUM TAX ANALYSIS

1982 ACTIVE COMPANIES WITH & WITHOUT NET INCOME
BASED ON ASSET SIZE (000 $ OMITTED)

ALL INDUSTRIES
(in millions)

| | TOTAL | ZERO ASSETS | 1 UNDER 100 | 100 UNDER 250 | 250 UNDER 500 | 500 UNDER 1,000 | 1,000 UNDER 5,000 | 5,000 UNDER 10,000 | 10,000 UNDER 25,000 | 25,000 UNDER 50,000 | 50,000 UNDER 100,000 | 100,000 UNDER 250,000 | 250,000 OR MORE |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| TAX ON PREFERENCE ITEMS: | | | | | | | | | | | | | |
| AMOUNT | 478 | 12 | 0 | 1 | 2 | 3 | 15 | 9 | 19 | 15 | 20 | 28 | 354 |
| PER CENT | 100% | 3% | 0% | 0% | 0% | 1% | 3% | 2% | 4% | 3% | 4% | 6% | 74% |
| REGULAR AND CAPITAL GAINS TAX: | | | | | | | | | | | | | |
| AMOUNT | 84,990 | 794 | 642 | 996 | 1,129 | 1,647 | 5,874 | 3,031 | 4,403 | 3,439 | 3,522 | 4,944 | 54,569 |
| PER CENT | 100% | 1% | 1% | 1% | 1% | 2% | 7% | 4% | 5% | 4% | 4% | 6% | 64% |
| INVESTMENT CREDIT INFORMATION: | | | | | | | | | | | | | |
| CREDIT GENERATED | 25,004 | 156 | 326 | 387 | 438 | 530 | 1,360 | 562 | 773 | 647 | 617 | 1,005 | 18,203 |
| CREDIT ALLOWED | 17,296 | 51 | 174 | 207 | 254 | 329 | 815 | 330 | 466 | 374 | 369 | 605 | 13,242 |
| CREDIT CARRYOVER | 7,708 | 105 | 152 | 180 | 184 | 201 | 545 | 232 | 307 | 273 | 248 | 400 | 4,961 |
| | 100% | 1% | 2% | 2% | 2% | 3% | 7% | 3% | 4% | 4% | 3% | 5% | 64% |
| ANALYSIS OF PROPOSED NET INTEREST PREFERENCE: | | | | | | | | | | | | | |
| INTEREST DEDUCTIONS | 515,009 | 28,613 | 4,126 | 3,452 | 4,300 | 5,787 | 15,875 | 7,398 | 13,815 | 17,868 | 23,152 | 32,192 | 358,431 |
| INTEREST INCOME | 515,608 | 28,403 | 2,691 | 1,490 | 1,788 | 2,440 | 6,632 | 4,512 | 12,429 | 18,933 | 25,223 | 32,655 | 378,412 |
| NET INTEREST EXPENSE | (599) | 210 | 1,435 | 1,962 | 2,512 | 3,347 | 9,243 | 2,886 | 1,386 | (1,065) | (2,071) | (463) | (19,981) |
| TOTAL DEPRECIATION | 213,119 | 2,002 | 5,253 | 5,725 | 5,927 | 7,157 | 16,161 | 6,248 | 7,942 | 6,276 | 5,863 | 9,366 | 135,199 |
| PERCENT | 100% | 1% | 2% | 3% | 3% | 3% | 8% | 3% | 4% | 3% | 3% | 4% | 63% |
| LONG TERM CAPITAL GAIN INFORMATION: | | | | | | | | | | | | | |
| AMOUNT TAXED AT 28% RATE | 12,023 | 345 | 8 | 39 | 48 | 167 | 619 | 361 | 736 | 418 | 433 | 654 | 8,213 |
| PERCENT | 100% | 3% | 0% | 0% | 0% | 1% | 3% | 3% | 6% | 3% | 4% | 5% | 68% |

## MINIMUM TAX ANALYSIS

1982 ACTIVE COMPANIES WITH NET INCOME

BASED ON INDUSTRY
(in millions)

| | ALL INDUSTRIAL DIVISIONS | AGRICULTURE, FORESTRY, & FISHING | MINING | CONSTRUCTION | MANUFACTURING | TRANSPORTATION & PUBLIC UTILITIES | WHOLESALE & RETAIL TRADE | FINANCE, INSURANCE, AND REAL ESTATE | SERVICES |
|---|---|---|---|---|---|---|---|---|---|
| TAX ON PREFERENCE ITEMS: | | | | | | | | | |
| AMOUNT | 411 | 1 | 60 | 6 | 175 | 45 | 36 | 69 | 11 |
| PER CENT | 100% | 0% | 17% | 1% | 43% | 11% | 9% | 17% | 3% |
| REGULAR AND CAPITAL GAINS TAX: | | | | | | | | | |
| AMOUNT | 84,990 | 490 | 3,203 | 2,070 | 45,006 | 11,356 | 11,572 | 7,607 | 3,806 |
| PER CENT | 100% | 1% | 4% | 2% | 53% | 13% | 13% | 9% | 5% |
| INVESTMENT CREDIT INFORMATION: | | | | | | | | | |
| CREDIT GENERATED | 19,606 | 136 | 522 | 333 | 8,682 | 5,938 | 1,763 | 1,075 | 1,157 |
| CREDIT ALLOWED | 17,296 | 118 | 426 | 323 | 6,721 | 6,287 | 1,575 | 805 | 1,041 |
| CREDIT CARRYOVER | 2,310 | 18 | 96 | 10 | 1,961 | (349) | 188 | 270 | 116 |
| | 100% | 1% | 4% | 0% | 85% | -15% | 8% | 12% | 5% |
| ANALYSIS OF PROPOSED NET INTEREST PREFERENCE: | | | | | | | | | |
| INTEREST DEDUCTIONS | 304,076 | 1,220 | 3,387 | 2,484 | 55,441 | 26,978 | 18,343 | 109,685 | 6,538 |
| INTEREST INCOME | 336,203 | 524 | 1,608 | 1,952 | 29,494 | 6,227 | 10,879 | 201,828 | 3,691 |
| NET INTEREST EXPENSE | (32,127) | 696 | 1,779 | 532 | 25,947 | 20,751 | 7,464 | (92,143) | 2,847 |
| TOTAL DEPRECIATION | 153,969 | 1,531 | 3,976 | 3,616 | 67,056 | 39,510 | 17,656 | 9,510 | 11,114 |
| PERCENT | 100% | 1% | 3% | 2% | 44% | 26% | 11% | 6% | 7% |
| LONG TERM CAPITAL GAIN INFORMATION: | | | | | | | | | |
| AMOUNT TAXED AT 28% RATE | 12,009 | 100 | 320 | 203 | 5,248 | 1,798 | 1,001 | 2,772 | 559 |
| PERCENT | 100% | 1% | 3% | 2% | 44% | 15% | 8% | 23% | 5% |

MINIMUM TAX ANALYSIS

1982 ACTIVE COMPANIES WITH NET INCOME
BASED ON ASSET SIZE (000 S OMITTED)

ALL INDUSTRIES
(in millions)

| | TOTAL | ZERO ASSETS | 1 UNDER 100 | 100 UNDER 250 | 250 UNDER 500 | 500 UNDER 1,000 | 1,000 UNDER 5,000 | 5,000 UNDER 10,000 | 10,000 UNDER 25,000 | 25,000 UNDER 50,000 | 50,000 UNDER 100,000 | 100,000 UNDER 250,000 | 250,000 OR MORE |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| TAX ON PREFERENCE ITEMS: | | | | | | | | | | | | | |
| AMOUNT | 411 | 4 | 0 | 1 | 2 | 3 | 14 | 9 | 17 | 16 | 13 | 23 | 309 |
| PER CENT | 100% | 1% | 0% | 0% | 0% | 1% | 3% | 2% | 4% | 4% | 3% | 6% | 75% |
| REGULAR AND CAPITAL GAINS TAX: | | | | | | | | | | | | | |
| AMOUNT | 84,990 | 776 | 642 | 996 | 1,129 | 1,647 | 5,875 | 3,032 | 4,417 | 3,651 | 3,658 | 4,881 | 54,286 |
| PER CENT | 100% | 1% | 1% | 1% | 1% | 2% | 7% | 4% | 5% | 4% | 4% | 6% | 64% |
| INVESTMENT CREDIT INFORMATION: | | | | | | | | | | | | | |
| CREDIT GENERATED | 19,606 | 46 | 202 | 250 | 300 | 387 | 945 | 363 | 509 | 436 | 444 | 730 | 14,994 |
| CREDIT ALLOWED | 17,296 | 45 | 174 | 207 | 254 | 329 | 816 | 330 | 467 | 400 | 400 | 678 | 13,196 |
| CREDIT CARRYOVER | 2,310 | 1 | 28 | 43 | 46 | 58 | 129 | 33 | 42 | 36 | 44 | 52 | 1,798 |
| | 100% | 0% | 1% | 2% | 2% | 3% | 6% | 1% | 2% | 2% | 2% | 2% | 78% |
| ANALYSIS OF PROPOSED NET INTEREST PREFERENCE: | | | | | | | | | | | | | |
| INTEREST DEDUCTIONS | 304,076 | 13,062 | 2,770 | 1,663 | 2,157 | 2,983 | 8,318 | 3,750 | 7,626 | 9,365 | 11,472 | 11,413 | 229,497 |
| INTEREST INCOME | 336,203 | 14,205 | 2,391 | 1,101 | 1,361 | 1,825 | 4,984 | 3,260 | 8,655 | 11,862 | 14,702 | 14,464 | 257,393 |
| NET INTEREST EXPENSE | (32,127) | (1,143) | 379 | 562 | 796 | 1,158 | 3,334 | 490 | (1,029) | (2,497) | (3,230) | (3,051) | (27,896) |
| TOTAL DEPRECIATION | 153,969 | 508 | 2,760 | 3,414 | 3,650 | 4,624 | 10,337 | 3,953 | 5,021 | 3,908 | 3,961 | 5,576 | 106,177 |
| PERCENT | 100% | 0% | 2% | 2% | 2% | 3% | 7% | 3% | 3% | 3% | 3% | 4% | 69% |
| LONG TERM CAPITAL GAIN INFORMATION: | | | | | | | | | | | | | |
| AMOUNT TAXED AT 28% RATE | 12,009 | 337 | 8 | 29 | 48 | 167 | 621 | 361 | 718 | 447 | 476 | 630 | 8,167 |
| PERCENT | 100% | 3% | 0% | 0% | 0% | 1% | 5% | 3% | 6% | 4% | 4% | 5% | 68% |

October 9, 1985

# STATEMENT
# OF
# CROWLEY MARITIME CORPORATION

Before the
Committee on Finance

Crowley Maritime Corporation supports the testimony presented to the Committee on Finance by Raymond Donohue, Vice President and Chief Financial Officer of Matson Navigation Company, Inc., on the capital construction fund issue.

This statement describes the devastating effect of terminating the capital construction fund provisions of the Merchant Marine Act upon Crowley Maritime Corporation, and upon the American merchant marine; upon the support functions of merchant vessels for the national defense; and upon the commerce of the United States, including particularly the services we render to the economies of Alaska, Hawaii and Puerto Rico; upon the services we render to the Navy in connection with the Distant Early Warning system in the Bering Sea and the service rendered to our Naval bases at Guantanamo Bay, Cuba, and Roosevelt Roads, Puerto Rico, as well as the vital cargo we deliver annually to the Prudhoe Bay oil fields.

Crowley made a contract with the United States for a capital construction fund. It kept its part of the bargain by depositing most of its earnings and using them to build in American shipyards for U.S.-flag operation. Now the government wants to repudiate that contract and leave us with immense unforeseen tax liabilities caused by our compliance with the contract.

The crippling effect of terminating the capital construction fund programs results in major measure from two factors. First, consistent with generally accepted accounting principles, our financial statements have made no provision for deferred taxes arising out of the CCF program. If CCF is repealed, such a provision would likely be required to be made in 1985. This charge to earnings would be so great that we would be in immediate default under all of our loan agreements, which either require us to maintain specified debt to equity ratios or contain so-called cross-default provisions. Second, the repeal of CCF would have a continuing adverse tax impact because of the combination of a reduced tax basis for depreciation for ships constructed with CCF withdrawals and the inability to offset those taxes by future CCF deposits.

During the next five years, certainly, and probably for the next ten years, the Treasury proposal would result in taxable income substantially in excess of book income. As a result, our annual tax liability would increase to between 60 and 190 percent of book income, as compared to a nominal rate in the Treasury proposal of 33 percent of taxable income. This would have a ruinous effect on our cash flow. It would also threaten our debt obligations of about 100 million dollars under government guaranteed financings pursuant to Title XI of the Merchant Marine Act, 1936, and would preclude for years the continued expansion and improvement of our fleet.

These harsh consequences would, moreover, be the result of a repudiation by the United States of its contract with our company under Section 607 of the Merchant Marine Act. The United States should defend, not repudiate, its contracts if it is to comply with its constitutional obligations. Finally, we are at a loss to understand why the Treasury proposal, while constituting a flagrant breach of the Government's contractual obligations, protects the larger benefits to those American companies which, through subsidiaries organized in foreign countries, continue to invest and reinvest their profits in foreign shipping without subjecting those profits to American income taxes.

The capital construction fund provisions of the law are in the Merchant Marine Act, 1936, not the Internal Revenue Code, and are one of the few remaining supports of the declining American Merchant Marine.

Before explaining in more detail how these drastic and disabling effects come about, it would be in order for me to describe briefly the history of our company and the range, variety and volume of services that we presently perform.

Crowley Maritime Corporation was founded 90 years ago with an 18-foot Whitehall boat providing transportation of personnel and stores to ships anchored in San Francisco Bay. Within a few years, services broadened to include Bay towing and ship-assist services. Acquiring more and larger vessels, the company expanded in the 1920's into Los Angeles Harbor with tug boats for ship-assist work and into Puget Sound with tug and barge transportation. Bulk petroleum transportation joined the company's list of services in 1939. In the 1950's we started our first common-carrier service - a container service - between U.S. West Coast ports and Alaska, a service presently performed by a subsidiary, Alaska Hydro-Train, transporting rail cars and, more recently, a roll-on/roll-off trailer service. In the early 1950's we began delivering bulk petroleum and dry cargo for the Defense Department's Distant Early Warning system in the Bering Sea and along the Aleutian chain and the service has continued to date. In the 1970's, we started a second common-carrier roll-on/roll-off service between Florida ports and Puerto Rico. In the 1970's we began a common-carrier service to Hawaii from U.S. Pacific ports. These two services provided real competition in the two major insular trades, holding down the rate levels and protecting their economies.

It is not coincidental that our major expansion coincided with the availability of the capital construction fund in 1972. From that year to last year, our annual revenues grew from about 50 million dollars to over 500 million dollars; and our investment in capital equipment from 112 million dollars to over 700 million dollars including over 400 vessels varying from small harbor tugs and supply boats to huge triple deck Ro-Ro trailer barges and two-deck rail-car barges. Attached are two schedules: one showing annual investment in capital equipment since 1972 and the other showing a current list of Crowley's vessels.

Crowley Maritime Corporation is a privately owned company in which the employees of the company participate in the equity ownership through the company ESOP. Most of the profits of the company are regularly reinvested in the company's business.

At the present time we operate our marine services through two divisions, the Pacific division and the Caribbean division. The Pacific division services the DEW line and performs the annual Sealift to Prudhoe Bay in support of crude oil operations on the North Slope. It supplies off-shore operations in the Beaufort Sea region between Point Barrow and Prudhoe Bay. Crowley's heavy lift service plays a major role by performing the loading and discharging of self-contained modules for the North Slope oil operations. Crowley has supplied and continues to supply, specialized ocean transportation service which permitted the development and exploration of the North Slope oil so vital to our economy and the national defense. The Pacific division also operates on the Columbia River carrying petroleum cargo up river and large volumes of grain down river. It engages in ship work on Puget Sound, San Francisco Bay and in the Los Angeles area. Crowley Environmental Services operates both commercially in Alaska, Puget Sound, San Francisco, Los Angeles and Puerto Rico, and under a contract with the United States Air Force for the treatment of contaminated ground water. The Pacific division operates Alaska Hydro-Train which offers a year-round weekly common-carrier service between Seattle, Washington, and Whittier, Alaska, (near Anchorage) with from 6 to 8 barges and 3 to 4 tugs. Hawaiian Marine Lines serves Honolulu every 21 days from Oakland, Portland, and Seattle, with 2 barges and 1 tug on each sailing. The Pacific division operates a common-carrier service from Seattle to Western Alaska with 4 or 5 sailings during the summer months extending from Bristol Bay to Point Barrow.

This division is also involved in tug and barge operations in Puget Sound, San Francisco and Long Beach Harbors, and engages in bulk petroleum transportation, ship bunkering, off-shore oil support and marine salvage. It also offers passenger ferry transportation to commuters and tourists on San Francisco Bay. A new high speed 400-passenger catamaran was introduced to the commuter service early this year.

Internationally the Pacific Division has provided specialized marine transport, oil drilling and other services in support of the off-shore oil and construction industries throughout the world, including Indonesia and in the Western Canadian Artic. Of particular relevance, its military support group initiated a new Far East service to haul clean petroleum products between military installations in Korea, Japan and Okinawa on a long term contract for the Military Sealift Command. The group also husbands 3 tankers in Japan for the Maritime Administration as a Naval reserve.

The Caribbean division through TMT is primarily engaged in the common carriage of trailerized cargo to Puerto Rico. It offers a weekly service from Petty Island in the Delaware River adjacent to Philadelphia; twice weekly service from Jacksonville, Florida and a weekly service from Lake Charles, Louisiana, and Mobile, Alabama. TMT operates the world's largest Ro-Ro barges. TMT provides cargo transport service to the Naval base at Guantanamo Bay and of course its regular common-carrier service supports the Naval Station at Roosevelt Roads, Puerto Rico. TMT is the recognized leader in providing dependable quality service to Puerto Rico. The Caribbean division through Crowley Towing and Transportation also provides long-term and daily contract-carrier services, harbor ship work and petroleum barge services throughout the Caribbean.

The divisions of Crowley Maritime Corporation have consistently expanded their equipment to meet the needs of the services which they perform, both in terms of volume and specialized requirements. Last year, for example, the Caribbean division converted 5 of its 400-foot triple-deck barges to 730-foot triple-deck barges by the construction and installation of prefabricated 330-foot mid-body sections. These 730-foot Ro-Ro barges, each with the capacity of 512 trailers, are the world's largest. The Pacific division, as indicated above, now employs a high speed 400-passenger catamaran vessel, the first time this revolutionary design has ever been used to carry passengers in the U.S. The Pacific division last year expanded the Alaska Hydro-Train volume and scope of service with the addition of a second deck on 3 barges, enabling the vessels to carry 105 highway trailers each, without altering the existing rail-car capacity. This enables Alaska Hydro-Train to deliver door-to-door trailer deliveries as well as siding to siding rail-car deliveries. A variety of specialized equipment has been acquired to meet the specialized needs of shippers; equipment such as heavy lift vessels, bulk urea vessels, an ice breaker barge, and in addition, specialized container equipment are designed to meet the particular needs of shippers. For example, by designing special equipment, Crowley's Caribbean division became a major carrier of bulk rice to Puerto Rico in 20-foot bulk containers sanitized for food carriage. Similarly, new reefer containers were acquired to solve the problems of packers of frozen chickens in shipping their product to market in Puerto Rico. Virtually all of this expansion and acquisition of specialized equipment was acquired with capital construction funds.

It has been pointed out that our net profits are reinvested in the business and services that Crowley Maritime Corporation and its subsidiaries perform. Our ability to expand through reinvestment of profits is directly dependent on the tax deferral provided by the capital construction fund program. As stated previously, we have consistently and regularly deposited a substantial portion of our taxable income into the CCF and our auditors, consistent with generally accepted accounting principles, have not required us to establish a reserve for the future liabilities arising from the deferral of current taxes. This is attributable to the fact that CCF was considered as a permanent program.

If the capital construction fund provisions of the Merchant Marine Act are terminated, as of the end of 1985 assets having a book cost of about 700 million dollars and a book value after depreciation of 420 million dollars will have a much lower tax basis. This means that our tax depreciation will be a fraction of our book depreciation. Under the Treasury's proposal our available tax depreciation would be about 265 million dollars less in total than our book depreciation. On an annual basis our book depreciation would be about 45 million dollars and our tax depreciation about 21 million dollars, which means that if we are not able to make deposits in a CCF, we would have taxable income of 24 million dollars more than book income (45 - 21 = 24). This situation would continue until the 265 million-dollar difference between tax and book depreciation is used up.

Depending on future income, our effective tax rate could range between 63 percent and 190 percent of book income. To take specific examples, if we earned 26 million dollars on our corporate books, our taxable income would be 50 million dollars, i.e., 26 million dollars plus 24 million dollars in less tax depreciation; the tax would be 16.5 million dollars, at the 33 percent rate, or a 63 percent effective tax rate on book income. In certain years in the past 10 years, we have earned as little as 5 million dollars. On earnings of 5 million dollars, the tax would be about 9.6 million dollars or about 190 percent of book net income.

As a result of this tax arithmetic, Crowley Maritime Corporation will probably be required to set up a very large reserve for future taxes until the 265 million dollar difference between book net income and tax net income is exhausted. Such a reserve on our corporate books would have a drastic effect on our debt/equity ratio and would put us immediately in default under all of our bank loan agreements. Cash flow would deteriorate and new investment would cease. Nothing in the Treasury proposal for relaxing the original proposed repeal of ACRS depreciation nor the reduction in maximum corporate rate from 46 percent to 33 percent would begin to ameliorate this devastating impact.

As a result of the greatly increased current tax liability, we would need to borrow heavily to make any capital investments, but as a result of default provisions under our bank loan agreements, we would probably be precluded from any additional borrowings until the tax liability was discharged. Indeed the drastic constraints on cash flow might well put us in substantive default under loan agreements and under 100 million dollars of Title XI indebtedness. As indicated above, in a year in which we had, say, a five million dollar net profit we would be obligated to pay almost 10 million dollars in federal income tax. Operating under such constraints we obviously could afford no future development of our services or expansion of our operations.

Indeed the negative effect on Crowley Maritime Corporation alone of repealing CCF is, all together, greater than the positive effect projected by the Treasury on the United States. If other companies incur the same adverse consequences as Crowley, the disproportion between the benefit to the United States and the painful damage to the Merchant Marine should render the proposal unacceptable to the United States as well as to the Merchant Marine. The maximum benefit to the public revenue estimated by the Treasury for CCF repeal is 80 million dollars annually and we strongly suspect that estimate is simply a rounding up to the lowest amount that the Treasury deemed worthy of stating.

Moreover, the capital construction fund is "capital-formation specific" Deposits in the capital construction fund defer taxes in the same way that accelerated depreciation does except that the cash flow from accelerated depreciation need not be reinvested in capital equipment and indeed there is no tax incentive to reinvest those funds in capital equipment. Deposits in the capital construction fund however, must be utilized to build or acquire vessels because the capital construction fund agreement requires a program of ship construction and acquisition. Moreover, once reinvested in vessels, the basis of the vessel is reduced by the amount of the reinvestment thus reducing future depreciation and increasing tax liability. This in turn is a powerful incentive to deposit an amount equal to the increased tax liability, thus commencing this cycle again. The Capital Construction Fund is the most powerful engine devised by Congress to stimulate capital investment. Once the company stops depositing and stops investing the consequences become disastrous. It is for this very reason that elimination of the capital construction fund would cause the extensive damage to our company that has been described.

The capital construction fund provisions of Section 607 of the Merchant Marine Act, 1936, are implemented by a capital construction fund agreement between the shipping company and the United States. The form of the agreement is published in 46 C.F.R. part 390, appendix II and appendix III. Among other things, it provides for a schedule of minimum deposits and a schedule of program objectives including in the latter, acquisition or construction of vessels, reconstruction of vessels, and payment of principal on existing indebtedness. The Maritime Administration does not permit companies to enter into agreements solely for the purpose of discharging existing indebtedness; the agreements must include the acquisition or construction or reconstruction of vessels. Companies like ours have long-range plans reflected in the program objectives in their capital construction fund agreement.

The Treasury II proposal would repudiate this agreement. There is a substantial likelihood that repeal of CCF in the manner proposed by Treasury could well be an unconstitutional taking of property by the United States which the Supreme Court has repeatedly enforced.

We are submitting for the record in this hearing, a legal memorandum setting forth this state of the constitutional law. But apart from the constitutional requirement that the government comply with its contracts, the inequity of terminating the capital construction fund and subjecting the companies to an abandonment of long-term vessel replacement, improvement and expansion plans, and imposing severe additional tax liabilities, is itself the most forceful reason for the legislators to reject the Treasury proposal.

So much for the treatment of American operators of U.S. flag-vessels. But how does the Treasury deal with the American operators of foreign flag-vessels? Under the Treasury proposal, an American corporation may form a wholly owned foreign company, Liberian, Panamanian and the like, to build and operate ships in world trades, earn income with those vessels and not pay any taxes on that income provided it continues to invest in foreign-flag operations. Indeed that reinvestment need not be in capital equipment of ships or containers or barges but may be used to expand current operations. Basically the foreign subsidiary pays income taxes only when the profits from foreign ships are declared as dividends and repatriated. Even under those circumstances it pays only the tax applicable in the year the dividends are paid. Under the capital construction fund agreement, if an operator of U.S.-flag vessels makes a nonqualified withdrawal from his capital construction funds, he pays the tax in the year in which withdrawn plus interest on the tax from the date the tax would have been paid if it had not been deposited in the fund. This can be a very severe penalty for a nonqualified withdrawal, which in any event requires the approval of the Maritime

Administration. Thus the foreign-flag operator is in a preferred tax position now and under the Treasury proposal will continue with its large benefits under the tax laws while the American operator suffers the consequences which has already been outlined. Strange facts that the Treasury thus greatly prefers the foreign-flag operator to the U.S.-flag operator.

It must be a basic assumption of the Treasury that a U.S.-flag fleet is an unnecessary luxury. The Treasury has afforded more rapid depreciation than pure economic depreciation in its proposal in order to encourage investment; it has actually reduced the capital gains tax in order to encourage investment; it continues, with modifications, IRAs and Keogh plans to encourage capital investment. All of this costs the public fisc a vastly greater amount of revenue than the capital construction fund program. Meanwhile the Treasury permits American operators of foreign flag ships privileges similar to, but greater than, those provided in the capital construction fund provisions of the Merchant Marine Act.

Lest we forget, a word of history from World War I, frighteningly relevant to todays conditions, may successfully dispute the Treasury's assumption. Then, as now, we had a small foreign trade merchant fleet. Now, though not then, that fleet is a world girdling fleet spending most of its time far distant from our own shores. When we entered the War in 1917, we desparately built shipyards to remedy the deficiencies. The most dramatic example of that Herculean effort was the Hog Island Shipyard near Philadelphia which built 50 ways and was designed to produce all kinds of ships quickly. Despite this immense effort, the first vessel produced by the Hog Island

Yard was delivered 3 months after the armistice was signed in 1918. The bridge of ships which carried and supplied the American expeditionary force in Europe was composed principally of our existing coastwise vessels.

The Harvard Report on "The Use and Disposition of Ships and Shipyards at the end of World War II" prepared for the United States Navy Department and United States Maritime Commission by the Graduate School of Business Administration at Harvard University, June 1945, echoes the same theme: "The contributions of domestic shipping to national security have often been overlooked by those who think in terms of foreign trade. Actually, in both World Wars domestic shipping has furnished more ships than those employed in foreign trade. All the coastwise and intercoastal ships of over 2,000 DWT's were requisitioned for use in this War, and the exploits of their crews have provided a glorious page in the history of the War." (at p. 90)

It may be argued that future wars will be waged so differently from past wars that no ships or shipyards will be required. The fact remains that a prudent government charged with the responsibility of guarding national security dare not take the risk of assuming now that such a condition will develop by the time it may again be called upon to defend the country in war or pursue its foreign objectives. American ships carried 80 percent of all the supplies required to support the allied war effort in World War II; virtually all the supplies sent to support the Korean conflict were carried by U.S.-flag ships; and an estimated 97 percent of all the war materials and supplies to Vietnam went in American built U.S.-flag vessels. Of course if we have a nuclear exchange, ships will be unnecessary, but that becomes a self-fulfilling prophecy. If we have not the means of conventional warfare, including ships, we may be driven to that kind of catastrophe.

Indeed the Congressional Budget Office, no friend of tax subventions, in a report on "U.S. Shipping and Shipbuilding Trends and Policy Choices" in August 1984, states categorically "both a review of history and thoughtful consideration of present international conditions suggest that cargo shipping is vital to U.S. national security. Separated from trading partners and allies by long ocean routes, the United States relies on shipping to sustain its economy and to support almost any kind of military operation." (at p. 45)

# WRITTEN STATEMENT OF THE
# EDISON ELECTRIC INSTITUTE
# ON THE CORPORATE MINIMUM TAX

The Edison Electric Institute (EEI) appreciates the opportunity to submit written comments for the printed record of the October 9, 1985 hearing before the Committee on Finance, U.S. Senate, on the corporate minimum tax.

EEI is the association of electric companies. Its members serve 96 percent of all customers served by the investor-owned segment of the industry. EEI members generate approximately 75 percent of all of the electricity in the country and provide electric service to 73 percent of the nation's consumers of electricity.

EEI believes that the foundation of the nation's tax system is predicated on the faith and perception that each taxpayer will pay a fair share of tax. EEI recognizes that in recent years the average individual taxpayer's confidence in our country's tax system has been shaken due to perceived abuses. Thus, there is a need to ensure that any abuses are corrected and that each taxpayer pays a fair amount of tax. EEI urges that any minimum tax legislation that may be enacted maintain as a central goal the need for fairness and equity.

In this regard, EEI has reviewed the corporate alternative minimum tax (AMT) proposals presented in the President's Tax

Proposals and also the corporate AMT proposed by the Staff of the Joint Committee on Taxation (JCT) in the options prepared for the House Ways and Means Committee. EEI offers comments on four specific areas associated with these corporate AMT proposals. They are listed immediately below and are discussed in detail in the narrative that follows. The four areas are:

1) the rate of minimum tax,
2) the non-expansion of tax preferences,
3) the investment tax credit offset, and
4) the comparison period.

The Rate of Minimum Tax

In the determination of the rate of a corporate AMT, EEI recommends consideration be given to the need to have a sufficient differential between the regular corporate income tax rate and a corporate AMT rate. If the regular corporate income tax rate and the corporate AMT rate were too close together, only a relatively small amount of tax preference items would be needed in order for a corporation to incur the AMT. This would result in the corporate AMT replacing the regular corporate income tax as the primary tax for many corporations for extended periods of time. By doing so, the regular corporate income tax, in effect, would be rendered a nullity.

Under current law, the add-on minimum corporate tax rate is 15 percent, and the regular corporate income tax rate is 46 percent;

thus, the minimum tax rate is about 33 percent of the regular tax rate. The corporate AMT rate as proposed by the President is 20 percent, with a regular corporate income tax rate of 33 percent; thus, the minimum tax rate would be about 61 percent of the regular income tax rate. The corporate AMT rate proposed by the JCT is 25 percent, with a regular corporate income tax rate of 35 percent; thus, the minimum tax rate would be about 71 percent of the regular income tax rate.

EEI recommends in any corporate AMT legislation that the corporate AMT rate not be greater than 50 percent of the regular corporate income tax rate.

The Non-Expansion of Tax Preferences

EEI believes that the list of tax preferences should not be expanded beyond those contained in the President's corporate AMT proposal.

The JCT option for a corporate AMT proposes to expand the list of tax preferences significantly. More specifically, the JCT option proposes to include as a tax preference all incentive depreciation in excess of non-incentive depreciation for property additions after December 31, 1985. In other words, the JCT has targeted all incentive depreciation, a capital-formation incentive, as a tax preference item. This expansion of preferences would discriminate against capital-intensive industries and would increase the cost of investment in plant and equipment. For taxpayers in such industries it is not realistic to enact such a broad expansion of the base for a corporate AMT, for such an expansion would further erode or even eliminate the incentive provided in the basic depreciation system and would result ultimately in an ongoing minimum tax liability for such capital-intensive taxpayers. Instead, any corporate AMT should focus principally on depreciation in respect to tax-shelter arrangements that have generated abuses by corporations.

## The Investment Tax Credit Offset

Under current law, taxpayers that have investment tax credit (ITC) carryovers and/or those that anticipate significant amounts of transition ITCs may be unable to utilize such credits if the ITC is repealed and if the corporate AMT proposal under either the President's proposal or the JCT options were enacted. Neither proposal would allow ITCs to be offset against the corporate AMT.

Under current law, taxpayers can look forward to ultimately utilizing ITC carryovers. However, both the President's and the JCT's proposals would deny the use of ITC carryovers and transition ITCs as offsets against a corporate AMT. Such denial would generally have an adverse impact on those corporations that can least afford it. The proposals would penalize corporations that relied upon existing provisions of the Internal Revenue Code when investment decisions were made. More specifically, the denial of the ITC as an offset against the corporate AMT would make the ITC, in effect, a tax preference. That treatment would be an unwarranted expansion of the list of tax preferences against capital-formation incentives.

### The Comparison Period

EEI would like to point out that electric utilities, as well as other businesses, often are subject to fluctuations in taxable income for reasons beyond the ordinary control of the taxpayer. In the case of electric utilities, rate regulation could have such an impact.

EEI recommends that a "comparison period" of at least three years be provided between the regular corporate income tax and an AMT. That is, a corporation should not be subject to the AMT when its liability for the regular income tax exceeds its liability for the AMT over any three-year period. The use of such a comparison period would ensure that taxpayers with fluctuations in taxable income do not pay substantial amounts of regular income tax in one year and minimum tax in another year, due solely to fluctuations in taxable income beyond their control. A similar provision has been proposed by the JCT under the AMT by which the AMT could be used as a credit against the regular corporate income tax. However, EEI's recommendation is that a comparison period of at least three years would be preferable to the JCT proposal.

### Conclusion

EEI believes that ongoing tax-reform efforts that would: (1) repeal the investment tax credit, and, (2) provide for a depreciation system with longer lives and slower recovery would have a direct adverse impact on capital-intensive industries such as the electric utility industry. To subsequently treat those remaining capital-formation incentives as tax preference items subject to the minimum tax would only exacerbate the problems of capital-intensive industries. EEI urges that any significant revenue enhancement be provided through the regular individual and corporate income tax system rather than through an AMT. The goal of any tax system, in EEI's view, is to ensure that each taxpayer pays a fair share of tax. If a corporate AMT is deemed to be necessary to ensure fairness of the income tax system, then EEI recommends that an AMT reflect the modifications described herein. The perceived abuses in the past should not result in an expanded minimum tax today, which attacks basic industries and which discriminates against capital formation.

EEI appreciates the opportunity to express its opinion through these written comments. We welcome the opportunity to work with the Committee in the development of effective tax-reform legislation.

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STEEL CATAMARAN
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MONTAUK PILOTS,INC.

Oct. 5,1985

Honorable Bob Packwood,Chairman
Senate Committee on Finance
219 Senate Dirksen Office Bldg.
Washington,D.C. 20510

Re: CCF program/hearing

Dear Senator Packwood:

Inasmuch as we cannot be present at the Finance Committee Hearing scheduled for Wednesday,Oct. 9,1985,regarding the future of NMFS's Capital Construction Fund Program,it would be greatly appreciated if the following letter were to be made part of the record of the hearing.

Ours is a small,family-owned business,a Small Business corporation. We are alarmed by the administration's proposal to abolish CCF. When we decided to establish a Capital Construction Fund we were, in effect,relying on the government's word that we could embark upon building a replacement vessel with the certainty that taxes would be postponed.

Together with what the business was able to put into the CCF,plus input from three generations of our family,we borrowed $400,000.00 from our local bank to build the new vessel. We did not seek a Fishing Vessel Obligation Guarantee. The new vessel went into operation on Aug. 24,1985;the old vessel was then withdrawn from service and has been placed on the market. We must sell it in order to reduce the enormous Demand Mortgage on the new vessel sufficiently to put it on an amortizing basis. This was the understanding with the bank,as it had not been feasible to wait until the existing vessel was sold before beginning construction of the new vessel. We would have been out of business during the entire period of construction.

It is at this point that CCF is supposed to be most helpful. The provisions of the agreement signed with NMFS allow for postponing immediate payment of capital gains taxes via reduction in the allowable depreciation schedule in an amount equivalent to what the tax would have been. It is the most important aspect of the whole program,as far as we are concerned. In order to reduce the Demand Mortgage to where we can live with it,we will need every cent we can glean from the sale of the old vessel.

If the Congress were to negate this provision of the CCF in midstream, it would put us in a very precarious situation; for if the funds needed to convert the Demand Mortgage were to be drained off to pay capital gains taxes instead, we would be extremely hard hit.

Without the CCF, we would have been hesitant to undertake this project. However, with the CCF we felt that we could commence construction with a clear head, confident that we would not get skinned alive with taxes when funds were needed the most. The government eventually gets its tax back through reducing the allowable depreciation.

We are painfully aware that this administration has been making every effort to clobber our industry from any angle it can, while on the other hand, foreign governments support their fishing industries to the maximum. As you know, unlike other American industries, ours is forbidden to go foreign in seeking reduced building costs. The administration should take that fact into consideration and not demand to have it both ways by snatching away the minimal help that has been extended to our industry via the CCF program.

And the very least that those of us who are in the midst of a CCF project should expect from our government is that it keeps its side of the bargain, that it keeps its word!

Sincerely,

Claire Glas

Claire Glas, Sec'y.
Montauk Pilots, Inc.
203-535-2066

CC: Honorable Dan Rostenkowski, Chairman
House Ways & Means Committee

NATIONAL ASSOCIATION OF LETTER CARRIERS
AFL-CIO

VINCENT R. SOMBROTTO
PRESIDENT

100 INDIANA AVENUE, N.W.
WASHINGTON, D.C. 20001
202 393-4695

TESTIMONY OF

VINCENT R. SOMBROTTO

NATIONAL ASSOCIATION OF LETTER CARRIERS

BEFORE

SENATE FINANCE COMMITTEE

ON

MINIMUM CORPORATE TAX

Oct. 9, 1985

Mr. Chairman. My name is Vincent R. Sombrotto, President of the National Association of Letter Carriers, a union representing 268,000 active and retired city letter carriers. The NALC also is one of the founders of CORECT, Citizens Organized to Restore an Effective Corporate Tax, a coalition of church, citizen and labor organizations.

In his May 28 speech to the nation, President Reagan said, "The free rides are over." We believe that the free rides should have ended years ago.

We're here saying that Congress needs to restore an old American tradition: fairness in taxes. As proof of our commitment, we have collected over 750,000 signatures on petitions.

If corporations don't pay their fair share of taxes, we will -- that is, we'll pay their share in addition to our own. The petitions say it best:

"We, the undersigned taxpayers, pay our fair share of taxes and more. It's time for our largest and most profitable corporations to pay their fair share, too.

"As people who pay our taxes, we are outraged by the $90 billion in corporate tax loopholes that allow America's most profitable corporations to pay little or nothing in taxes.

"When federal deficits are a problem, handouts to corporations are not the answer. By putting corporations back on the tax rolls, we can reduce the federal deficit and actually cut taxes for middle- and low-income taxpayers.

"In the interest of fairness to all taxpayers, we hereby petition the Congress of the United States to repeal these special interest loopholes and restore the corporate tax."

These petitions were easy to collect. As this committee knows, Americans are very sophisticated when it comes to taxes!

It does not escape their attention that corporations have a statutory tax level of 46%, yet the 250 major corporations' tax level from 1981-1983 was only 14.1%.

It does not escape their attention that over 1/2 of those 250 corporations paid either no taxes or received refunds in at least one of the three years studied! Sixty-five major US corporations, which collectively earned $49.5 billion in profits from 1981-1983, did not pay any federal tax during that same period. In fact, they received federal tax refunds totaling $3.2 billion. I call this an upside-down "transfer of payments" -- from the poor and middle class to the wealthy.

Some of the biggest rip-offs came from General Electric, which reaped $6.5 billion in domestic profits between 1981-83 and paid NO taxes. By taking advantage of loopholes, they robbed the Treasury of $282 million in rebates. Peter Grace, president of Grace & Co., stalks these halls self-righteously proclaiming that Congress lacks the "guts" to deal with the deficit. He talks about waste, fraud and abuse by day, but at night he devises schemes to break the Treasury: despite $684 million in profits, he made $12.7 million off the tax system by selling tax breaks.

In 1960, taxes from corporations averaged 25% of federal tax revenues. However, by 1984 that plummeted to 8.8%. The Congressional Budget Office reports that the average effective corporate tax rate has been cut in half since 1980. This amounts to a $90 billion welfare-to-the-unneedy program this year and skyrockets to $120 billion in 1986. We can not afford "corporate welfare" while child malnutrition, hunger and poverty in America increase daily. The connection between corporate tax-dodging and Reagan Administration proposals to cut our benefits and job security is that simple.

We propose examining a "radical" plan: make corporations pay taxes on their income just like working people. Currently, many corporations report one figure of profits to their shareholders, but report a totally different, much smaller figure to Uncle Sam. Taxes could be computed on the profits as reported to shareholders. In this way, the tax structure is both effective and fair, distinguishing between those who make money and those who don't. It's a way to make corporate taxes work.

Many corporations will complain that an effective, minimum tax puts them at an unfair disadvantage relative to foreign countries. Yet Japanese corporations are taxed on shareholder reports. Their corporate taxes supply 25-30% of Japan's national revenues, compared to our 8%. Congressional Research Service found that the Japanese effective corporate tax rate is close to 50%. But you don't hear them whining that they "can't compete."

Another corporate complaint is that they need more breaks to spur investment. However, the 50 companies which enjoyed the most tax breaks and averaged a negative tax rate actually reduced their capital spending by 21.6% between 1981 and 1983. In contrast, the 50 companies that paid the highest tax rates increased their investment by 4.3% -- despite an average tax rate of 33.1 percent.

Overall investment in plant and equipment, which was supposed to increase due to the Reagan 1981 tax plan, fell dramatically. Investment grew only 12.4% from 1981 to 1985, whereas it grew 31% from 1976 - 1980. The result translates into jobs: under President Reagan's plan jobs increased by only 5.7%, whereas jobs from 1976 - 1980 increased twice as much, 11.9%. These figures support our contention that a fair corporate tax leads to sound investments and more jobs.

Mr. Chairman, our petitions are an outpouring from enraged Americans. They come from all across this country - big cities, farm areas and retirement communities. They continue to pour in daily. The struggle for fairness and justice will be a long one. But it must be started. Let's begin here and make corporate taxes work. Fairness is as American as the Boston Tea Party.

I appreciate this opportunity to work with your Committee.

STATEMENT OF
FRANK DROZAK, PRESIDENT
SEAFARERS INTERNATIONAL UNION
OF NORTH AMERICA, AFL-CIO
SUBMITTED TO THE
COMMITTEE ON FINANCE
U.S. SENATE
October 1, 1985

On behalf of the Seafarers International Union of North America, AFL-CIO, which represents American seamen on all coasts, the Great Lakes, and on the inland waterways of the United States who are employed on U.S.-flag vessels engaged in the nation's foreign and domestic waterborne commerce, I appreciate the opportunity to express our views on several key provisions of the Administration's complex tax reform package and to determine what impact these proposals will have on the future of the maritime industry.

At the outset, permit me to say that we recognize and support the need to restructure and simplify the present tax system so that all sectors of American society are treated fairly and equitably in their financial obligation to the nation. However, although some features of the President's current tax reform package may have merit, many, in our opinion, do not meet the fairness criteria and, in fact, may lead to further inequities in the system. Certainly, several provisions in the tax reform package, if implemented, may well seal the doomed fate of the American merchant marine fleet and the nation's shipbuilding network.

We have repeatedly expressed in various legislative and executive branch forums our grave concern over the immediate and severe crisis that now confronts the American maritime industry. The facts are well known to all concerned interests. Therefore, there is no need to belabor the Committee with facts describing the deplorable state of the American merchant fleet and the domestic shipbuilding base. Suffice it to say that today's merchant fleet and complementary shipbuilding sector are a far cry from that intended by Congress in landmark legislative pronouncements in 1920, 1936, and 1970. Both are, indeed, progressively closer to the realm of extinction.

Although we are encouraged by the continued determination of many members of Congress to halt this steady decline and to proceed expeditiously toward realizing the resurgence of the industry, we are, on the other hand, dismayed at the misguided efforts of the Administration during the last four years to literally pull the rug out from under the maritime industry. Besides systematically dismantling key maritime promotional programs intended to encourage the maintenance of a strong and effective maritime industry, further steps to decimate the industry are once again on the horizon. These appear in the Administration's contemplated changes in tax policy as recommendations to terminate the business tax deduction for expenses incurred while attending meetings, seminars or conventions held aboard U.S.-flag passenger vessels, the repeal of the exclusion relating to the Capital Construction Fund program, and the replacement of the accelerated depreciation system with a less meaningful depreciation schedule.

The SIU strongly opposes the implementation of these proposals since they will prove disruptive to the maritime industry and, in fact, further exacerbate its already precipitous decline.

Recognizing the importance of U.S.-flag passenger vessels to the nation's economic and defense posture and aware of their marked absence in the nation's commercial fleet, the Congress, in the recent past, has wisely enacted several measures to encourage their revival under the U.S.-flag. In addition to permitting the reentry of the OCEANIC INDEPENDENCE and CONSTITUTION into the domestic passenger trades, the Congress, in 1982, corrected an inequity in tax law which had, through an oversight, automatically disallowed a business tax deduction for conventions held onboard U.S.-flag passenger vessels.

Nevertheless, extremely shortsighted bureaucrats would now revert this sector of the maritime industry to an inequitable pre-1982 tax standard. Stating that the present allowable deductions for conventions or meetings held aboard U.S.-flag passenger vessels "threaten public confidence in the system," the authors of the tax reform proposal fail to perceive the immediate national security and job creation potentials that justify this tax treatment.

We note the tendency among Administration spokesmen to dismiss U.S.-flag passenger vessels as being luxury items and, perhaps, irrelevant to any program for achieving a strong, efficient and highly productive merchant marine. Nothing could be less realistic or further from the truth than such an attitude. These vessels are powerful producers for our economy and our balance of payments as well as valuable auxiliary assets for our armed forces, at virtually no cost to the government.

Successful operation of these vessels creates employment potential, increases and enhances tourist potential, generates tax revenues, and provides the U.S. Navy with auxiliary vessels for hospital ship conversion or troop carriers on virtually immediate notice. The unquestionable value of passenger vessels as a national security asset can be clearly demonstrated from the fact that during the Grenada conflict, this Administration requested of the British government the standby availability of a British-flag passenger vessel for the transport of American nationals from Grenadian soil. Prior to this incident, the importance of a readily available merchant fleet was brought to light during the Falkland Island effort in which the British maritime flotilla included 49 commercial merchant vessels of which three passenger vessels were used as troop and hospital ships.

Nor has the national significance of passenger vessels escaped the maritime building program of the Soviet Union which numbered 87 militarily useful passenger vessels in 1983. On the other hand, currently there exists only two active U.S.-flag deepsea passenger vessels, operating in the Hawaiian Islands, which would be suitable and available to act as troop or hospital vessels in times of war or national emergency.

The availability of U.S.-flag commercial vessels to meet such defense priorities is, therefore, a key element in the formulation of any governmental policies dealing with the maritime industry, be they changes in the tax code or changes in promotional programs.

However, the future availability of these two vessels, which now capture only a minuscule portion of the $5 billion a year U.S. cruise market, the largest most lucrative business in the world, is in jeopardy. Also in jeopardy is the continued operation of two passenger paddlewheel steamboats, the DELTA QUEEN and the MISSISSIPPI QUEEN, operating on the inland waterways of the United States, as well as the continued revitalization of this sector of the commercial merchant marine fleet.

As you know, availability of U.S.-flag passenger vessels depends in large measure upon their ability to survive in a highly competitive commercial enterprise. An equitable competitive position is essential to any success in this effort. Allowing a business expense deduction for conventions held on U.S.-flag vessels currently affords the industry a measure of equity in competing with foreign and domestic land-based operations for a portion of the nation's convention business. Without this equitable tax provision, U.S.-flag passenger vessels will be unable to compete with these land-based facilities.

The proposal is not only discriminatory -- singling out one segment of our economy, the maritime industry -- but also unfair. It is based on an erroneous and preconceived notion that the current law is nothing more than a disguise for a tax deductible vacation, based on personal considerations, and, therefore, an abuse of the federal tax system. This is a myth and should be put to rest once and for all.

In current law, the burden of proof is on the taxpayer for he must attest to the fact that the primary purpose of the convention meeting was business and not pleasure. To deduct this shipboard convention expense, the taxpayer must fill out a myriad of reporting forms and meet stringent regulations, much more demanding than those reporting requirements applicable to land-based facilities.

In our view, the test of the deduction's validity is not the pleasantness of the surroundings but rather the substantiveness of the meeting. Regardless of location, hotel and vessel operators offer necessary meeting accommodations to facilitate meaningful professional forums. However, in the case of a shipboard convention, the audience is normally limited in size and essentially captive. Absence at required functions is noticeable. It is essentially much more difficult for a conventioneer to evade his commitment within the confines of a closed environment of a vessel than for that same individual to discretely absent himself from a meeting room in preference for a golf course, a ski slope or a theatrical presentation.

Furthermore, it makes no sense to permit a deduction for convention expenses at land-based hotels in Canada, Mexico or the 28 nations reaping the benefits of the Administration's Caribbean Basin Initiative program while denying the same equal treatment for a passenger vessel whose flag is an extension of American territory, whose owners are American citizens employing other American citizens , paying American corporate and personal taxes. It is bewildering to think that the federal government would discriminate against its own citizens and American operations, leaving them no alternative but to perhaps close their doors, in favor of foreign nations who are concerned with and building their own economies and encouraging their own tourism trade.

To tie the hands of American-flag companies in this manner, jeopardizing operations and the employment billets of hundreds of merchant seamen, simply because it is an American-flag passenger vessel service, while at the same time, through preferential tax treatment, encouraging conventions and meetings in foreign-based land facilities is arbitrary and capricious.

In closing this issue, it is folly to assume that the government will derive any savings or any increase in tax revenues by eliminating the business expense deduction for attending shipboard meetings, seminars or conventions. In reality, any individual denied this deduction on a water-based facility will opt to attend such a meeting at a land-based facility where this tax advantage would remain intact.

The SIU is frankly dismayed by the Administration's proposal to repeal this equitable tax deduction, since its implementation will surely halt the revival of the American-flag passenger fleet which provides tangible benefits to both national economic and defense security.

As I have indicated, several key maritime promotional programs have already been curtailed or totally abolished. The Administration's tax reform package recommends the abrogation of yet another vital and working program, the Capital

Construction Fund. Said to be perhaps one of the most important and influential provisions of the Merchant Marine Act of 1936, as amended in 1970, the Capital Construction Fund offers American shipping companies engaged in foreign, Great Lakes or the noncontiguous trades of the United States the opportunity to defer taxes on income deposited into the fund for the construction or reconstruction of vessels in domestic shipyards. The CCF permits the maximization of private American investment in the modernization of the American-flag fleet, a fleet built in American shipyards, using the skill of American craftsmen and products of American industry.

Without doubt, the availability of this tax deferral privilege has contributed to the modernization of the U.S.-flag merchant fleet. During the first ten years of the program's operation, 172 maritime operators entered into agreements with the Maritime Administration, 3,221 fishermen entered into agreements with the National Marine Fisheries Service, 199 deepsea vessels and 778 tugs, supply boats and other harbor vessels have been constructed or reconstructed with CCF funds. Disbursements from CCF's have provided full or partial financing of more than $5.2 billion for new vessel construction in U.S. shipyards.

Nevertheless, the Administration proposes to phase out the CCF program since its "national security justification ...is today unclear..." and since "U.S. citizens own or control large numbers of ships registered in Panama, Liberia, and Honduras that would be available to the United States in an emergency...."

Mr. Chairman, does the Administration by this statement intend to phase out American-flag shipping, per se? As incredible as that question may sound, in our view, that's exactly what may be happening. Abrogation of CCF agreements in conjunction with other negative decisions and actions taken by the Administration will add up to the economic destruction of the U.S.-flag merchant fleet.

As a result, this nation would be forced to rely on foreign-flag shipping for the carriage of all its commercial cargos as well as for its defense auxiliary needs, even though doubts persist about the availability, adequacy, and dependability of the effective U.S. control fleet to carry U.S. oceanborne commerce in time of national crisis. This can only be characterized as suicidal folly.

For years, this organization which I am privileged to represent has been in the forefront, along with others, in the war against so-called effective control vessels. We have questioned their availability, suitability, and reliability.

We have opposed American operators registering their vessels in foreign nations and crewing them with foreign nationals precisely because, in addition to the loss of tax dollars to the U.S. treasury, in addition to the increase in our balance of payments deficit, in addition to the loss of jobs for American seamen and American shipbuilders, we are most concerned with the probable and serious breach of economic and defense security if we rely on vessels registered in countries which may or may not have our best interest at heart. But to no avail. The government has turned a deaf ear to our warnings and has, in fact, through its tax policies encouraged the development of the so-called effective control fleet -- at the expense of the U.S. merchant fleet.

In our view, the time has come for the Administration to reverse its direction and to take the time to examine ways to revamp the nation's tax laws which are overly preferential to foreign-flag shipping entities instead of wasting its time and effort in suggesting the misguided repeal of programs aimed at achieving the revitalization of the U.S.-flag merchant marine fleet.

Mr. Chairman, I must say that once again this Administration has demonstrated a profound lack of understanding of the U.S.-flag merchant marine and its importance to both the nation's economic and defense security.

Although the Administration solemnly reiterates the essentiality of an adequate merchant marine for both commercial and national defense purposes, with a concomitant need for a strong shipbuilding base, this maxim is unattainable within the means the government is willing to expend.

Therefore, the SIU respectfully requests that the Committee reject the Administration's tax reform package in its application to the repeal of the CCF program, the denial of business deductions for conventions held onboard U.S.-flag passenger vessels, as well as the proposed changes in the depreciation schedules.

In our opinion, these proposals are self-defeating, compounding the immediate and long-range problems of the U.S.-flag merchant marine, threatening the very existence of the maritime industry.

Thank you.

Shipbuilders
Council of America
1110 Vermont Avenue, N.W. ▪ Washington, D.C. 20005 ▪ (202) 775-9060

STATEMENT
OF

M. LEE RICE
PRESIDENT
SHIPBUILDERS COUNCIL OF AMERICA

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

DEPARTMENT OF THE TREASURY
PROPOSED TAX LEGISLATION AND
ITS EFFECT ON THE U.S. MERCHANT MARINE

OCTOBER 9, 1985

Mr. Chairman and members of the Committee, I am M. Lee Rice, President of the Shipbuilders Council of America, the national trade association representing the principal domestic shipbuilders, ship repairers, and providers of equipment and services to the industry. A list of our membership is attached to this statement.

## BACKGROUND

On behalf of the Reagan Administration, the Department of the Treasury has proposed sweeping revisions to the Internal Revenue Code. The package contains, among other things, two important changes which adversely affect the privately-owned, U.S.-flag fleet. The first of these changes is the elimination of the Capital Construction Fund (CCF) provisions of current law. The second change is not directed solely at shipping and shipbuilding as is the CCF elimination but will also have a highly negative effect. This is the elimination of investment tax credit (ITC) and the modification in the asset life of vessels. This latter change affects both the international fleet and the Jones Act fleet but in different ways.

For many years prior to the enactment of the Economic Recovery Tax Act of 1981, the American maritime industry had argued that successful competition in the international trade required equivalency between the cost and tax base of U.S.-flag operators and their foreign competitors. Parity both in the levied tax on income and in capital recovery were needed.

The CCF provisions were supported to achieve parity with the generally "untaxed income" of foreign-flag operators even though this was not really the case. Yet, it was a cornerstone of the arguments to support CCF. As to capital recovery, there was no real attempt to achieve tax parity. Vessel life was fixed at an average of 18 years. With the enactment of Public Law 97-34 in 1981, vessel life was reduced to five years. Capital recovery became, on the average, reasonably equivalent to the capital recovery of other major maritime nations. Of course, some nations retained a major advantage in allowed capital recovery. For example, the United Kingdom continues to allow her operators to expense the cost of commercial vessels.

## PROPOSED TAX LEGISLATION

### A. CCF Provision Elimination

The CCF program, set forth in section 607 of the Merchant Marine Act of 1936 and not the Internal Revenue Code, is designed to encourage the construction, reconstruction, and acquisition of vessels built in domestic shipyards for the international, noncontiguous domestic, Great Lakes, and fisheries fleets. Maritime and fisheries operators enter into binding contracts with the federal government which allow them to defer income tax on certain funds to be employed for an approved vessel construction program. The deferred tax is subsequently recaptured by the U.S. Treasury through reduced depreciation because the tax basis of vessels constructed, reconstructed, or acquired with CCF monies is reduced and this increases the taxable income of the ship operator.

It is proposed that the CCF provisions be eliminated. The Treasury Department states that the "national security justification for subsidies of U.S. maritime construction is unclear" and that U.S. citizens "own or control large numbers of ships" available to the United States in an emergency and "most U.S. allies possess substantial fleets" that would be available in any common emergency. This basis given by the Department of the Treasury to support this proposal is totally in error. A great deal of work has been done to support the retention of CCF and to show the error of the proposed elimination. The attached letter from the Federation of American Controlled Shipping to Congressman Mario Biaggi, Chairman of the House Merchant Marine Subcommittee, clearly shows the fallacy of the Treasury Department position.

In our view, the elimination of CCF will cause a reduction in the demand for new construction of vessels for the Jones Act trade. Together with the bias from a cash flow point of view toward existing ships resulting from the elimination of ITC and lengthened asset life for vessels, elimination of CCF will clearly eliminate Jones Act new vessel demand and as a consequence have an important negative effect on the size and capability of the shipyard mobilization base.

B. Capital Recovery Modification

1. International Fleet

The changes proposed in the tax legislation, elimination of investment tax credit and extention of the depreciation life of vessels from five to ten years, with the only offset being a reduction in the tax rate on earned income, returns the U.S.-flag operator to the status of the significant capital recovery disadvantage that existed prior to 1981. Shipping is a capital intensive business. Further, national policy presumes that successful commercial operation of our international fleet will cause operating vessels to be available to meet the needs of the nation for military purposes in time of war or an emergency.

The U.S.-flag fleet is rapidly being reduced in numbers by intense international competition, and a number of authorities both within and without the federal government predict that the trend will continue and most likely accelerate. It should be obvious that changing the capital recovery of U.S.-flag operators vis-a-vis their foreign-flag competitors will exacerbate the problem. Adding the elimination of CCF at the same time completely distorts parity.

Cash flow from operations is a much more important measure than a reduction in tax on earned income. This is because operating earnings of U.S. operators are at best low and will continue to be highly depressed for the foreseeable future. Under these conditions, the ability of shipowners to replace inefficient vessels with modern units and/or to increase their fleets will be extremely difficult. As a consequence, a cornerstone of our national security planning, namely, that merchant vessels will be provided through commercial operation at low or no cost to the government, will be lost.

### 2. Jones Act Fleet

Nearly the entire supply of commercial tanker vessels which could partly serve the needs of the military in a national emergency are the vessels that operate under the protection of the Jones Act. However, this supply of tankers will become highly deficient over the next few years. Attached is a study by the Tanker Study Group examining the question of the inventory of tankers. This group was established under the auspices of the Department of Transportation's Maritime Advisory Committee.

In addition, the recent decision of the Transportation Department allow repayment of Construction-Differential Subsidy (CDS) to qualify tanker tonnage previously precluded from the coastwise trade will produce an oversupply which will last for a significant period. This action will accelerate the decline of militarily-useful tankers. There is extensive documentation on this issue available from congressional testimony and pending court actions.

In the Jones Act trade, owners of the cargo also own and/or control a large part of the needed tanker tonnage. The major petroleum companies (e.g., Exxon, Sohio, and Arco) have, in general, operating profit levels which are high compared with those of the independent ship operators in the Jones Act. Thus, an immediate bias is created in favor of the major companies where the reduction in income tax rates is much more important as an element of cash flow to them than to the independent operators.

Coupling CDS repayment with the change in capital recovery under the proposed tax law produces a highly likely exclusion of future investment to replace the large number of vessels owned and operated by the independent ship operator which form the underpinning of our national security shipping inventory.

Again, national planning which presumes that the Jones Act will continue to supply a large part of the required inventory of militarily-useful tanker vessels becomes defective. Although this would likely be caused by the CDS repayment decision alone, the proposed tax changes significantly exacerbates a most serious problem.

## CONCLUSION

The Treasury Department's proposed tax legislation will have a detrimental effect on the privately-owned, U.S.-flag operator. These changes, if enacted, will adversely effect both the operator engaged in the international market as well as in the Jones Act trade. These effects, in turn, will be felt by U.S. shipbuilders who depend upon the U.S.-flag operators for their business. Most importantly, the changes will further erode the U.S.-flag feet as a national security asset which can be called on by the government in time of war or national emergency.

ATTACHMENT

**REGULAR MEMBERS**

ADDSCO Industries, Inc.
Mobile, AL

The American Ship Building Company
Tampa, FL
Tampa Shipyards, Inc., Tampa, FL

Avondale Shipyards, Inc.
New Orleans, LA

Bath Iron Works Corporation
Bath, ME

Bay Shipbuilding Corporation
Sturgeon, WI

Bethlehem Steel Corporation
Bethlehem, PA
Beaumont, TX
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Dillingham Maritime Group
Portland, OR

FMC Corporation
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General Dynamics Corporation
St. Louis, MO
Electric Boat Division, Groton, CT
  and Quonset Point, RI
Quincy Shipbuilding Division, Quincy, MA
  and Charleston, SC

General Ship Corporation
East Boston, MA

Hoboken Shipyards, Inc.
Hoboken, NJ

Ingalls Shipbuilding Division
Litton Industries
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Lockheed Shipbuilding Company
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Marine Power & Equipment Company, Inc.
Seattle, WA

Marinette Marine Corporation
Marinette, WI

National Steel & Shipbuilding Company
San Diego, CA

Newport News Shipbuilding
Newport News, VA

Norfolk Shipbuilding & Drydock Corporation
Norfolk, VA
Norfolk, VA (2 plants)
Berkeley, VA

Pennsylvania Shipbuilding Company
Chester, PA

Peterson Builders, Inc.
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Southwest Marine, Inc.
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San Francisco, CA
San Pedro, CA

Todd Shipyards Corporation
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San Francisco, CA, Seattle, WA

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## ASSOCIATION MEMBERS

The American Waterways Operators, Inc.
Arlington, VA

New England Ship Repair Yard Association
East Boston, MA

New York and New Jersey Dry Dock Association
New York, NY

South Tidewater Association of Ship Repairers, Inc.
Chesapeake, VA

Western Shipbuilding Association
San Francisco, CA

FACS FEDERATION OF AMERICAN CONTROLLED SHIPPING
50 Broadway, New York, New York 10004 212-344-1483 "AMCOMSHIP"

Telex No. 701979
Answer Back FACS NYKUD

Philip J. Loree, Chairman
Eugene A. Yourch, Executive Secretary

August 20, 1985

The Honorable Mario Biaggi
Chairman
Subcommittee on Merchant Marine
Committee on Merchant Marine
& Fisheries
U. S. House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

I was in Europe at the time of your Subcommittee's hearing on July 11, 1985, which heard testimony on both the impact of the Treasury Department's proposed tax revisions on the maritime industry and H.R. 2893. Since then I have had the opportunity to review the testimony at your hearing, and would like, in this letter, to express our views on some of the issues under consideration. I would appreciate it if you would include this letter as part of your hearing record.

1. Proposed Elimination of Section 607

In proposing the elimination of the Section 607 deferral for U.S. flag vessels, the Treasury Department has contended that "A national security justification for subsidies of U.S. maritime construction is today unclear." It also has pointed to the "large" number of open registry vessels controlled by U.S. citizens and available to the U.S. in the event of a national emergency (the EUSC fleet), as well as to our allies' fleets of oceangoing merchant ships. The Treasury Department believes that these maritime assets sufficiently meet U.S. national security needs, and thus justify the elimination of tax and subsidy support for the U.S. flag fleet.

We cannot accept this analysis. Over the years we have consistently testified that the EUSC fleet is not a substitute for a strong and economically viable U.S. flag merchant fleet. If anything, the two fleets can be viewed as supplementing and complementing each other. Elimination of one fleet because of the existence of the other would, in our opinion, give rise to obvious national security problems.

The EUSC fleet clearly has a mixed role in terms of providing emergency sealift coverage. Under present planning 93 of the 399 EUSC ships are considered by U.S. defense planners to have direct military utility. The remaining 306 vessels are primarily liquid and dry bulk carriers. Their role in a war or national emergency is to maintain the flow of critical oceanborne raw materials such as oil, ores, coal and chemicals. In comparison, the 198 tankers and 176 container and general cargo vessels in the privately owned U.S. flag fleet have a greater direct military support capability, but considerably less utility in terms of transporting vital raw materials during war or national emergency.

The EUSC fleet has comparatively few container vessels and general cargo vessels, while the U.S. flag fleet has very few bulk carriers, combination vessels and chemical carriers, and only a limited number of large crude carriers. Without belaboring the point, we believe that it is wrong to suggest that either one of these fleets could be a substitute for the other in terms of meeting all U.S. national security needs. Rather, they should be considered together. Both fleets are of crucial importance to U.S. defense planning.

The availability to the United States of our allies' merchant vessels during war or national security is subject to two serious caveats. One is that in a more limited emergency (such as the Viet Nam conflict) the United States may not have the active support of those allies controlling the largest merchant fleets. The second is that even in a war or national emergency where the allies wholeheartedly support the United States' efforts, the operational control of their commercial fleets will likely remain with them, not with the United States. These caveats do not apply with respect to the EUSC and U.S. flag fleets.

Moreover, the Treasury Department's proposal fails to recognize that, because of the critical economic state of the maritime industry today, the numbers of both EUSC and U.S. flag vessels are declining substantially. The ongoing reductions in both these fleets promise to make adequate emergency sealift coverage even more problematical in the future than it is today. If anything, this consideration suggests that from the standpoint of the national security, U.S. policy clearly should be to preserve these maritime assets, rather than to discourage their future economic viability.

Here it must be emphasized, as Treasury Department officials have correctly testified on past occasions, that there is really no such thing as a "tax advantage" in international shipping. Virtually every nation with a viable merchant fleet effectively shields its owners from immediate taxation on current income by one means or another. As a practical matter, shipping operations -- be they Greek, British, Norwegian, Japanese, Danish, Hong Kong Chinese, German or open registry -- have tax parity with their competitors.

Essentially the same tax parity has been accorded U.S. flag operations through a variety of provisions. These include the ability to place earnings and profits into Section 607 tax deferred construction reserve funds, the eligibility, first, for flexible depreciation (called asset depreciation range or ADR) and, then, for greatly accelerated depreciation (accelerated cost recovery system or ACRS), the availability of investment tax credits, and the ability to apply shipping losses to offset non-shipping income.

The Treasury proposals regarding Section 607 (as well as decelerated depreciation and investment tax credits) fail to recognize that while tax deferral offers no competitive advantage in international shipping, its elimination would constitute a tremendous disadvantage. Competitors of other nationalities could continue to modernize and rebuild their fleets with tax deferred income while U.S. flag operators would be subject to current taxation and thus would suffer sharp reductions in their cash flows, and in many cases would be unable even to amortize loans on their existing vessels. The eventual impact of these proposals, if enacted into law, would be to force U.S. flag operations out of business, thereby dissipating the national security benefits they presently provide.

In the same vein, we do not believe that the Treasury proposals adequately address the precarious state of U.S. commercial shipbuilding which -- with the cessation of construction subsidies and with the ability of subsidized ship operators to purchase new tonnage abroad -- essentially must rely on two incentives to encourage the building of commercial vessels in U.S. yards. Those incentives are, of course, the Jones Act build-American requirement and Section 607. We believe that in time of war or national emergency there is a national security need to have a shipbuilding base in the United States capable of repairing and, depending on the length of the emergency, building commercial ships. Those needs alone justify the continuation of Section 607.

Finally, we note that the Treasury Department estimates that elimination of Section 607 would produce negligible tax revenue in the first year and perhaps $100 million per year in following years. These estimates seem overly optimistic, considering the many problems now facing the domestic flag fleet, and the bleak economic outlook for international shipping in general. In any event, the national security implications outlined above clearly outweigh the estimated tax revenues.

For the above stated reasons we believe that Section 607 should be continued in its present form.

### 2. Proposed Deposits of Subpart F Income in Section 607 Funds (H.R. 2893)

One provision in H.R. 2893 would permit U.S. shareholders of controlled foreign shipping corporations to deposit Subpart F income in Section 607 funds. We believe that the likely impact of this provision on stimulating new construction in U .S. yards would be minimal, at the very best. It is highly improbable, in this prolonged period of depressed earnings (or, more accurately, substantial losses), that American shareholders controlling foreign flag shipping operations would have funds available for such deposits. Even assuming the availability of such funds, it is equally improbable that there would be any interest -- considering the unavailability of construction and operating subsidies -- in using Subpart F income to build U.S. flag ships in U.S. shipyards to compete in the international trades with capital costs at least three times, and operating costs at least three to five times, those of foreign competitors. Nor is there any reason to believe that such companies would be undertaking any meaningful construction of vessels for the Great Lakes trades, which are now severely depressed, or the non-contiguous domestic trades, now more than fully tonnaged.

Of course, under the present provisions of Subpart F, earnings of controlled foreign shipping corporations may be invested in vessels built in U.S. shipyards for registry abroad. The reason that this option is rarely, if ever, exercised is because U.S. shipbuilding costs and delivery dates are simply non-competitive compared to those of foreign yards, not because of some shortcoming in Subpart F.

While the practical consequences of permitting American shareholders to deposit Subpart F income in Section 607 funds would be virtually meaningless, the proposal would, in theory at least, nonetheless provide American companies with an additional means of obtaining tax deferral on shipping income. In this respect it would, we believe, run counter to current tax policy within the Treasury Department. At the same time, it would subject American companies to criticism in the future for having a twofold tax deferral advantage or, equally undesirable, for not making use of the Section 607 option, despite the fact that the option itself is an unrealistic one.

We firmly believe that the present Subpart F approach, which is based on an intricate framework of laws and regulations developed over the past quarter century, adequately and realistically defines the parameters of deferral for U.S. shareholders of controlled foreign corporations, and that any linkage between Subpart F and Section 607 is clearly unnecessary and would only create future problems. Consequently, we urge that the reference to Subpart F income in H.R. 2893 be deleted in its entirety.

Sincerely,

Philip Loree

PJL:VE

# OUTLOOK FOR
# MILITARILY USEFUL
# AMERICAN-FLAG TANKER TONNAGE
# 1985-1989

REPORT TO

THE SECRETARY OF TRANSPORTATION

BY THE

TANKER WORKING GROUP, MARITIME ADVISORY COMMITTEE

Ran Hettena
President
OSG Bulkships, Inc.
Chairman

James R. Barker
Chairman
Moore McCormack Resources, Inc.

Adolph B. Kurz
President
Keystone Shipping Co.

July 1985

# INTRODUCTORY

This report is substantially limited to analysis of the supply of tankers defined to us as militarily useful, with a projection of known economic trends that will determine the size of this fleet to the end of the decade. At the beginning of our study, the Secretary of the Navy furnished us certain military demand "scenarios" of apparent specificity, and we also received testimony examining civilian shipping requirements for full mobilization. However, the premises of these scenarios seem to be undergoing reconsideration both on the military and civilian side, and do not therefore provide a sufficient basis for comparing potential war demand with supply. Since present and predictable supply depends on commercial factors essentially independent of war demand (unless government policy intervenes to modify them), it has seemed best to let the fleet analysis stand alone. Those who have the responsibility will be able to fit the data of supply into their contingency plans, making such reciprocal policy adjustments as they may deem required either in the scenarios that simulate demand or in government policy that might on the other hand stimulate supply.

Our study shows a commercial fleet much diminished from recent peak levels, and points to trends continuing to decline. We mention physical factors that reduce the effectiveness of efforts to offset this decline by using ships up to 100,000 dwt. The same factors that have produced these results in this country have operated in the world market. The fleets of our NATO allies and of American owners under flags of convenience have declined even more sharply to a point where it is unrealistic to expect them to provide any meaningful reinforcement for our requirements. The same judgment applies to the commercial world fleet as a whole, which, still gripped by a profound depression after scrapping 100 million tons of tankers in four years,.is continuing to scrap at the rate of 25 million tons a year — more each year than the entire American tanker fleet. This aspect of physical supply leaves out of account any question of crew reliability. At the same time, allied shipbuilding capacity has dropped by half in ten years, and the peacetime production base now rests in the Far East, chiefly Japan and Korea.

Our report does not deal with expedients for addressing the problem of any undersupply that planners may consider exists. Our historic national system, under which the government acquires defense capability as a cheap by-product of the commercial market, which bears most of the cost (the whole cost in the case of coastwise shipping), appears to be in the process of being dismantled. It must therefore be left to those who bear the responsibility for national defense to address the shipping problem.

## SUMMARY

1. The whole private U.S. tanker fleet at the end of 1984 comprised 197 units of 13.9 million dwt. The number defined as militarily useful (coated and up to 100,000 dwt) was 149 of 6.7 million dwt (with government tonnage numbering 22 of 535,000 dwt). The private fleet averaged about 11 years as a whole, and those militarily useful about 15. This is because the preponderance of recent new construction has concentrated in the larger crude-carrying sizes, responding to Alaskan commercial demand, while 96 of the ships most desired for defense are still in the handy size below 40,000 tons; despite heavy scrappage in the last three years, these still average about 17 years, and 55 are over 20 years. This class must expect still further shrinkage next year, about 60 becoming then subject to statutory and regulatory clean-ballast requirements that will render some of them uneconomic.

The decision to rely upon larger tankers presents certain physical problems that should receive study. Military peacetime experience has been limited to handy-size tankers, which have more or less ready access to refinery installations and channels around the world. Ships above 50,000 tons cannot achieve such access at full draft, and must therefore load or complete loading elsewhere. Facilities for this process are at present almost entirely lacking. In addition, zinc tank coatings of ships equipped with inert gas systems for the crude trade are known to be attacked by chemical reactions that make them unsuitable for military refined products. Of the 50 ships in the fleet ranging between 50,000 and 92,000 tons, only 14 have the necessary protective epoxy coating.

2. The end-1984 fleet of 149 militarily useful tankers may be compared with 186 of 7.8 million tons as recently as 1982. During the next five years, the following negative factors appear likely to operate.

a. Atlantic coastwise demand for petroleum products has been falling without interruption since the early 1970s, and this trend has not merely cyclical but structural elements representing a change from heavy fuel oil and distillates to alternative energy sources. In addition, competition and growing Colonial pipeline capacity have largely displaced tanker movements from the Gulf to the North East. The remaining tanker demand is heavily concentrated in the Gulf-lower Atlantic trade, where it is vulnerable to potential pipeline displacement.

b. The fairly substantial intra-regional trade is moving increasingly by barge.

c. The previously vigorous intercoastal products movement has virtually disappeared. Some crude movement from California is anticipated, utilizing Panamax tankers in the range 50,000-90,000 dwt.

d. The total decline in products carriage is striking. In 1974, 147 out of 220 tankers engaged in clean trading, amounting to 4.5 million dwt; in 1984, only 53 out of 190 were so engaged, 1.7 million dwt, a drop from two-thirds to only one-quarter of the fleets operating in the respective years.

3. At year-end 1984, 41 militarily useful ships aggregating 2.5 million tons were engaged in various phases of the Alaskan crude trade, amounting to 31% by number and 42% by capacity of all militarily useful tonnage. Assuming offset of Prudhoe Bay decline by other Alaskan discoveries and fairly substantial California production, total tanker demand may by 1989 recover from the 1985 estimate of 6.3 million dwt to or slightly above the peak 1982 level of about 7.0 million dwt. Continuing recovery of West Coast production would operate negatively, enhanced by impending expansion of product export privileges.

The only other substantial market for the class of tankes in question is the Military Sealift Command, which at end 1984 employed 22 ships aggregating 700,000 tons. However, military POL distribution is driven by the same economics as the commercial market in peacetime, because the responsible organizations are required to lay down clean petroleum at the cheapest price. Expanded military use of the Colonial pipeline is expected in 1985. If the pipeline is extended into Craney Island (Norfolk area), JP-5 will commence to move in 1986, eliminating two tankers.

Other preference markets are exiguous.

4. From the foregoing, it appears that the employed tankers deemed militarily useful will decline from about 5.8 million tons this year to about 5.0 million tons by the end of the decade, of which fully half will be engaged in the Pacific Basin crude trade. With perhaps ten more ships idle at that time, the total militarily useful fleet would be 121 units of 5.6 million dwt. This means deletion of 38 vessels from the private fleet during the next five years, about 1.25 million dwt. Six of these are assumed transferred to the reserve fleet. All are under 50,000 dwt, but a number of the larger crude units are also approaching the end of economic usefulness.

5. Because of our information that the scenarios previously furnished us by the Secretary of the Navy are no longer current, we have not undertaken to compare the resources we have described with contingent wartime demand, whether military or civilian. However, because of the obvious question whether they would be adequate for any large scale contingency, we have examined possible non-flag sources of tonnage. These include (1) U.S. owned ships under foreign flag of convenience, (2) NATO fleets, and (3) the remaining world fleet. The same economic factors that have affected the American fleet have operated with even greater force in the world market. In mid-1984, the effective control fleet contained only 32 tankers within the size range and of reasonable

age; of 500 such ships reported by NATO, over 200 have disappeared, and the three largest fleets (Greece, Italy and U.K.), which originally were reported as containing 372 units among them, are down to 206 (from 12.9 million dwt to 7.9 million), without adjustment for coating or age (the Greek and Italian fleets exceed 20 years on average). It is extremely doubtful that NATO, which has no known commitment to supply us with tankers, could physically do so to any meaningful extent. As for the remaining world fleet, it has been shrinking at an extraordinary pace, which although somewhat slowed is still at an annual rate of 25 million dwt, more each year than the whole American tanker fleet. This wholesale scrapping is not limited to VLCCs, of course. Within the time studied, no significant surplus of products tankers is likely. The question of price during emergency should also not be taken for granted, as is sometimes done. We also note that new construction is now practically limited to the Far East, and the bare facilities for building are rapidly being closed down in the NATO countries.

6. If a war emergency is likely to require tankers for direct military service and for industrial and civilian purposes, a number of expedients suggest themselves for preserving and perhaps enlarging our resources. However, these suggestions necessarily assume that national shipping policy is to continue in something like its historic form. It is

obvious that such an assumption is hardly tenable at present. The advantage of the policy was that it enabled government to procure a defense instrument as a cheap by-product of ordinary commerce. In view of the evident change of policy, it would not be useful to advance suggestions for expanding or maintaining the fleet.

# REPORT OF
# TANKER WORKING GROUP

This report assesses factors affecting the fleet of American flag tankers considered suitable for direct military use. For the past few years the stock of such vessels has been declining rapidly, and further reduction is likely, considering forces working to reduce the market for handy and medium size tankers. We also consider possible other sources of this class of tonnage in emergency.

## I. THE CURRENT AMERICAN TANKER FLEET

The privately-owned U.S. Flag tanker fleet at the end of 1984 consisted of 197 units with a carrying capacity of about 13.9 million deadweight tons.[1] The private fleet of coated tankers up to 100,000 dwt defined as suitable for military purposes is 149 units with a capacity of 6.7 million dwt. In addition, government-owned tonnage, both active and in the reserve fleet, aggregated 22 vessels of 535,000 dwt.

The average age per deadweight ton of the privately owned tanker fleet was approximately eleven years at the end of 1984, a significant reduction over the past few years. This mainly reflects the surge of construction for the Alaskan trade in the late 1970s, delivery of large subsidized tankers during the mid-1970s, a moderate volume of new construction of small tankers in the early 1980s, and the accelerated scrapping of old handy-size tankers in recent years. The preponderance of new construction over the past decade, however, has been in vessels considered too large for direct military use.

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[1] Excludes vessels reported as sold for scrap, but not yet delivered to demolition yards. Integrated tug-barges and specialized tankers also are excluded, and vessels below 6,000 dwt.

A summary of the fleet census is shown in Table I. For comparative purposes, the group of militarily useful tankers in the private fleet at the end of 1982 aggregated 186 vessels of 7.8 million dwt. Two years later this fleet was down 20% in number and 14% in carrying capacity.

TABLE I
Summary of U.S. Tanker Fleet Census
December 31, 1984

| | Number | 000 DWT | Weighted Average Age/DWT |
|---|---|---|---|
| Private Fleet, Total | 197 | 13,902 | 11.3 yrs. |
| Militarily Useful Fleet, Total | 149 | 6,716 | 14.7 yrs. |
| 6,000-39,999 dwt | 96 | 3,153 | 17.5 yrs. |
| 40,000-99,999 dwt | 53 | 3,563 | 12.2 yrs. |
| Gov't. Owned Fleet | | | |
| Active | 2 | 54 | 27.5 yrs. |
| RRF | 9 | 259 | 27.6 yrs. |
| NDRF | 11 | 223 | 39.0 yrs. |
| Total | 22 | 535 | 32.3 yrs. |
| Grand Total-Militarily Useful Fleet | 171 | 7,252 | 16.0 yrs. |

*Age reflects in the case of rebuilt vessels an average of the stern and new or upgraded midbodies.

NOTE: Data may not add to totals due to rounding.

Further analysis of the fleet age composition reveals a still heavy concentration of older vessels in the handy-size tanker class, notwithstanding the record rate of demolition. Of the 149 ships in the private fleet considered useful by the Navy, 55 were over 20 years of age, even after reflecting the installation of new midbodies, and of the most flexible tonnage — ships below 40,000 dwt — 45 are in excess of 20 years.

It is in fact the small, flexible products tanker that has suffered the greatest contraction in number and the largest incidence of idling and lay-up.

In addition to aging and shrinking demand, the competitive position of this segment of the fleet will be adversely affected by rules that by the beginning of 1986 will require segregated or increased clean ballast capacity on tankers 15 years old or above and between 20,000 and 40,000 dwt. Approximately 60 ships were in this class at the end of 1984 and it is anticipated that a large number will become uneconomic once the rules take effect.

While the Navy's preference historically has been for handy-size ships able to operate in shallow waters, the recent and prospective decline in the availability of small coated products tankers has forced a reevaluation and the decision to use larger coated U.S. flag vessels as required. As a result, this analysis includes tankers with capacities in excess of 90,000 dwt.

The age distribution of the fleet, by size class, is shown in Table II and includes vessels under construction at mid-1984. Table III presents the same distribution by carrying capacity.

Table II
AGE PROFILE
NUMBER OF U.S. FLAG TANKERS BY SIZE AND AGE*
December 31, 1984

| Tanker Size Range (DWT) | Under Construction | Age (Years) 0-5 | 6-10 | 11-15 | 16-20 | 21-25 | 26-30 | 31 & over | Total |
|---|---|---|---|---|---|---|---|---|---|
| 6,000 - 39,999 | 5 | 7 | 24 | 13 | 9 | 18 | 20 | 9 | 105 |
| 40,000 - 49,999 | 0 | 4 | 0 | 0 | 0 | 5 | 3 | 0 | 12 |
| 50,000 - 79,999 | 0 | 6 | 1 | 12 | 5 | 8 | 0 | 0 | 32 |
| 80,000 - 99,999 | 0 | 0 | 13 | 6 | 0 | 0 | 0 | 0 | 19 |
| 100,000 - 149,999 | 0 | 3 | 6 | 3 | 0 | 1 | 0 | 0 | 13 |
| 150,000 - 199,999 | 0 | 4 | 6 | 0 | 0 | 0 | 0 | 0 | 10 |
| 200,000 and over | 2 | 2 | 9 | 0 | 0 | 0 | 0 | 0 | 13 |
| Total | 7 | 26 | 59 | 34 | 14 | 32 | 23 | 9 | 204 |
| Militarily-Useful | | | | | | | | | |
| 6,000 - 39,999 | 5 | 7 | 22 | 13 | 9 | 18 | 18 | 9 | 101 |
| 40,000 - 99,999 | 0 | 10 | 11 | 17 | 5 | 7 | 3 | 0 | 53 |
| Total | 5 | 17 | 33 | 30 | 14 | 25 | 21 | 9 | 154 |

Table III
ACE PROFILE
TONNAGE OF U.S. FLAG TANKERS BY SIZE AND AGE
December 31, 1984 (000 DWT)

| Tanker Size Range (DWT) | Under Construction | Age(Years) 0-5 | 6-10 | 11-15 | 16-20 | 21-25 | 26-30 | 31 & over | Total |
|---|---|---|---|---|---|---|---|---|---|
| 6,000 - 39,999 | 150 | 247 | 806 | 494 | 310 | 599 | 628 | 215 | 3,448 |
| 40,000 - 49,999 | 0 | 170 | 0 | 0 | 0 | 247 | 123 | 0 | 539 |
| 50,000 - 79,999 | 0 | 309 | 80 | 837 | 313 | 462 | 0 | 0 | 2,001 |
| 80,000 - 99,999 | 0 | 0 | 1,176 | 486 | 0 | 0 | 0 | 0 | 1,662 |
| 100,000 - 149,999 | 0 | 379 | 745 | 370 | 0 | 114 | 0 | 0 | 1,608 |
| 150,000 - 199,999 | 0 | 722 | 1,058 | 0 | 0 | 0 | 0 | 0 | 1,781 |
| 200,000 - and over | 418 | 796 | 2,217 | 0 | 0 | 0 | 0 | 0 | 3,431 |
| Total | 568 | 2,624 | 6,082 | 2,187 | 623 | 1,422 | 750 | 215 | 14,470 |
| Militarily-Useful | | | | | | | | | |
| 6,000 - 39,999 | 150 | 247 | 727 | 494 | 310 | 599 | 561 | 215 | 3,303 |
| 40,000 - 99,999 | 0 | 479 | 1,004 | 1,241 | 313 | 404 | 123 | 0 | 3,563 |
| Total | 150 | 726 | 1,731 | 1,735 | 623 | 1,003 | 684 | 215 | 6,866 |

Note: Data may not add to totals due to rounding.

The new decision to rely upon large tankers to transport clean products has its difficulties, however. Two physical problems connected with the expanded conception of military utility have been drawn to the DOD's attention. These relate to the accessibility of refineries to the large ships, which bears upon their actual usefulness, and certain aspects of tank coating that may also represent an important limitation.

The coating problem is straightforward. The law requires vessels trading in crude oil to be equipped with inert gas systems as a safety measure. These systems produce sulphur products that attack tank coatings of inorganic zinc. Of the 43 coated tankers between 50,000 and 100,000 dwt listed in Table IV, 26 are zinc coated, 14 are epoxy coated and the remainder are coated with a combination of the two materials. The same condition also affects most of the ships in the 40-50,000 ton range, most of which have been trading in crude and are subject to the IGS requirement. The cost of substituting epoxy for zinc is material, having been estimated by the Maritime Administration as long ago as 1978 at between $2 and $3.5 million for ships in the sizes in question; recoating a 38,000-ton tanker recently cost nearly $5 million for a high quality application. There is no commercial necessity to change the coatings. In addition to cost, recoating of the vessels would require several months of shipyard time.

Table IV

U. S. Flag Tankers 50,000 to 100,000 DWT

| Vessel | Owner | DWT | Tank Coating |
|---|---|---|---|
| Chesapeake | Hess | 50,023 | IZ |
| Potomac Trader | Attco | 75,057 | E |
| Delaware Trader | Attco | 50,057 | E |
| Petersburg | Keystone | 50,063 | N |
| Chesapeake Trader | Attco | 50,116 | E |
| Ogden Hudson | Ogden | 50,852 | IZ/E |
| Ogden Dynachem | Ogden | 50,852 | IZ/E |
| Bennington | Keystone | 50,848 | IZ (Partial) |
| Exxon Baltimore | Exxon | 51,926 | IZ |
| Exxon Boston | Exxon | 51,966 | IZ |
| Pennsylvania Sun | Sun | 53,463 | N |
| Texas Sun | Sun | 53,453 | N |
| Baltimore Trader | Attco | 57,884 | E |
| Overseas Alaska | OSG | 62,005 | E |
| Overseas Arctic | OSG | 62,005 | E |
| Golden Gate | Keystone | 62,115 | E |
| Cove Liberty | Cove | 69,306 | IZ |
| Arco Prudhoe Bay | Arco | 70,278 | IZ |
| Arco Sag River | Arco | 70,215 | IZ |
| Chevron California | Chevron | 70,213 | IZ |
| Chevron Mississippi | Chevron | 70,213 | IZ |
| Sansinena II | Union | 70,459 | IZ |
| Cove Leader | Cove | 71,054 | IZ |
| Exxon Houston | Exxon | 71,540 | IZ |
| Exxon New Orleans | Exxon | 71,508 | IZ |
| Copper Mountain(ExPtVail) | Point Shipping | 71,791 | E |
| Overseas-Natalie | OSG | 72,677 | IZ (Partial) |
| Exxon Baton Rouge | Exxon | 75,600 | IZ |
| Exxon San Francisco | Exxon | 75,600 | IZ |
| Exxon Philadelphia | Exxon | 76,160 | IZ |
| Adonis | Apex Marine | 79,804 | N |
| Sohio Resolute | Trinidad | 80,569 | IZ |
| America Sun | Sun | 80,735 | IZ |
| Glacier Bay | Trinidad | 80,759 | IZ |
| Sohio Intrepid | Trinidad | 80,773 | IZ |
| Ogden Yukon | Ogden | 81,116 | E (Partial) |
| Ultrasea(O/B/O) | Apex Marine | 82,120 | N |
| Ultramar(O/B/O) | Apex Marine | 82,199 | N |
| Arco Texas | Arco | 89,900 | N |
| Overseas Chicago | OSG | 90,637 | E |
| Oversea New York | OSG | 90,393 | E |
| Overseas Ohio | OSG | 90,564 | E |
| Overseas Washington | OSG | 90,515 | E |
| Chestnut Hill | Keystone | 91,295 | IZ/E |
| Kittaning | Keystone | 91,344 | E |
| Golden Monarch | Apex Marine | 91,388 | IZ |
| American Heritage | Apex Marine | 91,849 | IZ |
| Beaver State | Apex Marine | 91,849 | IZ |
| Rose City | Apex Marine | 91,849 | IZ |
| Golden Endeavor | Apex Marine | 91,849 | IZ |

IZ = Inorganic Zinc
E = Epoxy
N = No Coating

| | | |
|---|---|---|
| Zinc Coated Vessels | - | 26 |
| Epoxy Vessels | - | 14 |
| Zinc/Epoxy | | 3 |
| Uncoated Vessels | - | 7 |
| Total Vessels | | 50 |

The refinery access problem is a function of (1) the physical dimensions of ships in relation to the dimensions of refineries that produce fuels of military grade and of terminals at the reception end of the operation; and (2) the carrying capacity of ships in relation to the production and storage capacity of refineries and of such reception terminals. An excess of ship size and capacity in any one of these relations represents inefficiency, greater or less in particular instances, but requiring careful analysis and practical experiment to minimize if significant reliance is to be placed on larger ships. It must be remembered that until the present, the Military Sealift Command has never employed tankers over 50,000 dwt for peacetime military purposes.

Table V sets out some typical tanker types ranging from 37,000 dwt to 90,000 dwt, giving their physical dimensions in length, beam and draft. Ships below 50,000 tons draw between 35 and 40 feet; ships larger than 50,000 tons cluster respectively around 52,000 tons, 62,000 tons, 72,000 tons, 80,000 tons, and 92,000 tons. On average, the 50,000-ton class draw 39 feet, with a range of 36-41 feet; the 60,000 and 80,000 ton classes average 44 feet, with a range of 43-47 feet; those in the 70,000-ton class average about 43 feet, with a range of 41-46 feet; and the 90,000-ton class 49 feet.

## Table V
## Tanker Sizes

| | DWT at 40 Ft. | Total DWT | LOA | BEAM | DRAFT |
|---|---|---|---|---|---|
| Bethlehem 37,000 Class | | 37,300 | 660 | 90 | 37 |
| Nassco Coronado Class | | 39,700 | 688 | 90 | 35 |
| Chevron Gas Turbine Class | | 39,500 | 650 | 96 | 38 |
| Exxon Jamestown Class | | 41,000 | 715 | 93 | 39 |
| Overseas Joyce Class | | 49,840 | 736 | 102 | 40 |
| Bethlehem 62,000 Class | 55,800 | 62,000 | 731 | 105 | 43 |
| Overseas Natalie | 58,800 | 72,680 | 860 | 105 | 46 |
| Exxon San Francisco | 46,000 | 75,600 | 809 | 125 | 54 |
| Sohio Resolute | 42,000 | 80,569 | 811 | 125 | 57 |
| Nassco San Clemente Class | 69,400 | 90,000 | 894 | 106 | 49 |

## Table VI
## JP-4, JP-5 Refineries

| Name | Location | Dk. Lgth. | Dk. Draft | Restrictions |
|---|---|---|---|---|
| Chevron | Pascagoula | 750 | 36 SW | - |
| Exxon | Baton Rouge | 950 | 40 FW | - |
| Shell | Norco | 900 | 40 FW | 40 Air Draft |
| GATX | Good Hope | 900 | 40 FW | 41-6" Air Dra<br>75000 DW Max. |
| Mobil | Beaumont | 875 | 39 FW | 105 Beam |
| Petrofina | Pt. Arthur | 900 | 40 FW | Bow to manifc<br>450 ft. |
| Gulf Oil | Pt. Arthur | 775 | 38 FW | Bow to manifc<br>387 ft.<br>119 Beam |
| Texaco | Pt. Arthur | 800 | 35 FW | NA |
| Exxon | Baytown | 810 | 40 SW | 39000 DW Max. |
| Hess | Houston | 750 | 40 FW | 173 Air Draft<br>105 Beam<br>55000 DW Max. |
| Koch | Corpus Christi | 900 | 40 SW | 138 Air Draft |
| Coastal | Corpus Christi | 900 | 40 SW | - |
| Coastal | Corpus Christi | 900 | 40 SW | - |
| Coastal | Corpus Christi | 900 | 38 SW | - |
| ARCO | Long Beach | 900 | 43 SW | 105 Beam |
| ARCO | Long Beach | 700 | 40 SW | 135 Beam |
| Union Oil | 149-150 | 1200 | 35 SW | - |
| Chevron | El Segundo | 1000 | 40 SW | NA |
| Chevron | El Segundo | 1000 | 40 SW | NA |
| Chevron | 98-101-102 | 800 | 35 SW | NA |
| Exxon | Benicia | 1100 | 34 LW | 70 Air Draft |
| Shell | Deer Park | 860 | 40 FW | 120 Beam |
| Shell | Deer Park | 725 | 40 FW | 110 Beam |
| Shell | Deer Park | 800 | 40 FW | 110 Beam |
| Shell | Martinez | 740 | 40 LW | NA |
| Shell | 169-168-167 | 1000 | 35 SW | NA |
| Arco | Cherry Point | 968 | 65 SW | - |
| Manchester Fuel | Washington | 534 | 40 MLW | NA |
| Muckateal | Washington | 1300 | 38 LW | NA |

The two chief military product groups are jet fuels of various grades and diesels of marine grade. These have constituted over 90% of recent MSC liftings.

A comparison of the physical characteristics of the ships above 50,000 tons with characteristics of 29 refineries producing JP-4 and JP-5 shown in Table VI makes apparent that physical constraints will tend to limit the employment of the large vessels.

Thus, the important Mobil installation at Beaumont cannot accept ships over 50,000 dwt. Gulf at Port Arthur would exclude two-thirds of the ships by its 775-foot dock length. Exxon at Baytown is limited to 39,000 tons and Hess in Houston, at present an important transfer facility, is limited to 55,000 tons.

Aside from such exclusions, the refinery facilities restrict full use of the cargo capacity of large tankers by reason of their respective average depths. For the docks, the average depth is 37.5 feet; only six ships above 50,000 tons draw less than 40 feet, and only four more are 40 feet: the others are 41-49 feet. The weighted average loss of capacity is 18%, with a range of 11-28%. The 80,000-ton group lose 20%, becoming in effect 65,000 tons; with the same percentage loss, the 60,000-ton ships become 50,000 tons.

Reinforcing the dock characteristics in this respect are typical channel depth limits, which would in any case exact a sacrifice of capacity.

Facilities for reception of cargo also represent a limiting factor. Present military facilities in the United States and throughout the world number about 100, of which 40 or more provide 34-foot draft or less, or can otherwise accommodate ships not more than 35,000 dwt. Only one-third have depths 39-45 feet or more.

These physical constraints are further augmented at present by the limited output and storage facilities for military fuels at all refineries, both here and abroad. Few can provide cargoes exceeding 210,000 barrels, or 30,000 tons. In 1982, over 60% of MSC loadings were in quantities only half that amount, necessitating multiple loading calls even for handy tankers.

Since no ship over 50,000 tons has actually operated in clean military trade, the mechanics for topping off must at present be theoretical. Some of the physical problems are suggested by a consideration of present conditions in the Gulf. A ship drawing more than 40 feet would presumably load to that depth at the refinery dock; as the stream is similarly limited, her loading could only be finished outside in the Gulf. Barges now available are not seaworthy outside the breakwater, and are mainly in dirty trade, so that it is not going too far to say that local facilities are not readily available for this form of topping off, without regard to delays that the use of these barges would entail (about 32 hours for a single 6,000-ton delivery from refinery into ship) and the large number of units that would be required to service a significant number of ships in continuous transit.

It is possible to see the direction of study. Recoating is a function only of money and time. What is fundamental to industrial war policy is whether the ships can in practice be articulated with the physically accessible refineries in such a way as to maximize utilization of cargo space. For instance, can whole refineries having such accessibility be devoted exclusively to military fuels, and if so can this be done on a scale adequate to meet military demand? The risks of excessive concentration must naturally also be assessed.

It should be mentioned that under the principal scenario originally placed before us the scale of military POL shipments from the United States anticipated for a global war greatly exceeds present movements. Other than the SPR, the worldwide MSC lift in the whole of FY 1984 was 87 million barrels, of which 49 million barrels were loaded in the continental United States and Caribbean, equivalent to about 135,000 b/d. For planning purposes, the volume of oil required for full scale conventional war shipments from the

Gulf Coast CONUS to the various theaters of war has been estimated at a rate above 1.1 million b/d. We gather that dispersion to individual theater sources of supply is being studied, with a view to reducing reliance on CONUS.

## II. OUTLOOK FOR THE TANKER FLEET

### A. DEMAND FACTORS

The development of the U.S. tanker fleet has reflected a number of major structural and regulatory changes over the past decade that have altered the composition of demand. In addition, changes in the course of Federal promotional policies with respect to bulk vessels first stimulated and then restricted the participation of American tankers in world trade. At this time, the combination of market forces and the absence of policies that could stimulate the growth of U.S. tanker employment are together driving the fleet to a smaller number of units not particularly responsive to military needs.

From 1973, the privately owned tanker fleet grew from about 8.0 million to a peak of 15.0 million dwt in 1982, thereafter declining to an end-1984 level of 13.9 million dwt. Virtually the whole expansion was of crude carriers over 100,000 dwt. At the beginning of 1973 there were two such tankers in the U.S. inventory; by the end of 1984, there were 34, aggregating more than 6.0 million dwt. An additional 16 crude carriers between 80,000 and 100,000 dwt, totalling 1.4 million dwt, were delivered during the same period.

The major part of this construction was specifically for the new Alaskan oil trade, which has tended to expand since its commencement in 1977. Somewhat earlier, under provisions of the Merchant Marine Act of 1970, a flow of subsidized VLCCs and medium-size tankers occurred for the foreign trade.

1. Gulf-Atlantic demand.

The positive developments tended to obscure the deep attrition that was developing in the historic trades for domestic tankers, especially in the Gulf/East Coast movements of crude oil and refined products. Doubling of the Colonial pipeline, construction of the trans-Panama pipeline and the decline of the preference trades also served to reduce demand for small and medium-size tankers.

While some of the decline in Gulf/East Coast movements occurred prior to 1979, particularly in crude oil shipments, which fell without interruption from the early 1970s, much of the contraction has taken place since 1979. Table VII, shown below, establishes the recent trend in East Coast products supply.

Table VII
Source of Petroleum Products Supplied to the East Coast
(Million B/D)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1979-84 Change |
|---|---|---|---|---|---|---|---|
| Gulf Pipelines | 2.03 | 2.03 | 2.01 | 1.99 | 1.91 | 1.94 | ( .09) |
| Local Refiners | 1.69 | 1.55 | 1.48 | 1.38 | 1.24 | 1.31 | ( .38) |
| Imports | 1.50 | 1.20 | 1.12 | 1.04 | 1.16 | 1.32 | ( .18) |
| U.S. Barge/Tanker from PAD III | 1.05 | .99 | .85 | .79 | .73 | .67 | ( .38) |
| | 6.27 | 5.77 | 5.46 | 5.20 | 5.04 | 5.24 | (1.03) |

Lower demand for refined products has been a major factor explaining the fall in tanker demand. To the extent lower oil demand is a result of structural rather than cyclical changes, the recent lower levels of East Coast oil requirements largely represent a permanent change by reason of fuel substitution and conservation measures. Of the 1.0 million b/d decline in oil products supplied to the East Coast between 1979 and 1984, about one-half was concentrated in lower requirements for heavy fuel oil, which experienced an erosion of its markets to alternative energy sources. Distillates experienced a similar, largely permanent, reduction in demand.

As demonstrated in Table VII, all supply sources were affected by the contracting East Coast markets. However, products pipeline shipments into the East Coast fell only 4%, while tanker movements from the Gulf decreased 36%. The latter figure does not fully describe the decline in tanker demand. The shorter haul movements from the Gulf to the Southeast, including Florida, have been fairly well maintained while the longer haul services to the Northeast have fallen steeply. In competition with the Colonial Pipeline and imports in a declining market, waterborne shipments of the main clean products to New England and the Central Atlantic States dropped an average 61% in five years.

Table VIII
U.S. Gulf/East Coast Clean Products Shipments
by Tankers and Barges (000 B/D)

| | New England | Middle Atlantic | Lower Atlantic | Total |
|---|---|---|---|---|
| 1979 | 170.3 | 151.6 | 512.9 | 834.8 |
| 1980 | 100.4 | 75.4 | 509.7 | 685.5 |
| 1981 | 61.0 | 47.7 | 474.5 | 583.2 |
| 1982 | 46.3 | 61.8 | 464.4 | 572.5 |
| 1983 | 42.1 | 75.7 | 471.2 | 589.0 |
| 1984 est. | 40.0 | 85.0 | 450.0 | 575.0 |
| % Change - 1984 vs 1979 | -76.5% | -43.9% | -12.3% | -31.1% |

Includes gasoline, distillates, jet fuel, aviation gasoline, and kerosene.

Source: U.S. Department of Energy.

The recent slight improvement in shipments to the Middle Atlantic region is attributable mainly to the severe decline of spot freight rates which made seaborne movements at times competitive with pipeline tariffs.

2. Intra-regional demand.

In addition to movements of refined products from the Gulf to the East Coast, significant volumes of product are distributed intra-regionally. The Corps of Engineers publishes information that, together with information on ship employment, can be used to derive waterborne volumes. This information also separates cargoes lifted by barges and tankers. For many years, barge units, including both ITBs and conventional tug-barge systems, have gained a steadily greater market share at the expense of tankers, especially in short-haul intracoastal trades in the Gulf and East Coasts. That trend likely will persist.

Table IX
Tanker & Barge Competition in Coastal
Refined Products Trade (Million B/D)

| | 1979 | 1980 | 1981 | 1982(e) | 1983(e) |
|---|---|---|---|---|---|
| Gulf to East Coast | | | | | |
| Tanker | .92 | .85 | .70 | .64 | .57 |
| Barge | .13 | .14 | .15 | .15 | .16 |
| | 1.05 | .99 | .85 | .79 | .73 |
| East Coast | | | | | |
| Tanker | .28 | .24 | .19 | .17 | .16 |
| Barge | .45 | .50 | .57 | .58 | .54 |
| | .73 | .74 | .75 | .75 | .70 |
| Gulf Coast | | | | | |
| Tanker | .17 | .19 | .13 | .12 | .11 |
| Barge | .11 | .10 | .15 | .14 | .16 |
| | .28 | .29 | .28 | .26 | .27 |
| West Coast | | | | | |
| Tanker | .32 | .35 | .32 | .30 | .29 |
| Total | | | | | |
| Tanker | 1.69 | 1.63 | 1.33 | 1.23 | 1.13 |
| Barge | .68 | .74 | .86 | .87 | .86 |
| | 2.37 | 2.37 | 2.19 | 2.10 | 1.99 |

(e) = Estimated
Source: U.S. Department of Energy, U.S. Army Corps of Engineers, Maritime Administration.

### 3. Intercoastal and offshore demand.

While the Atlantic/Gulf and Pacific services account for the bulk of the domestic waterborne trade in refined products, a significant volume from time to time has moved in intercoastal trade (between the West Coast and Gulf or East Coasts), and in noncontiguous trade (mainly between Puerto

Rico and the Virgin Islands and the East Coast). In addition, vessels engaged in foreign trade should be noted, including ships performing MSC charters. Finally, many militarily useful ships have been employed in the crude oil trade.

The decontrol of crude oil prices and the loosening of controls on exports of refined products from the United States damaged the competitive position of domestic refiners, and most particularly the ability to move by U.S. tanker a high volume of refined products between the coasts. With the export alternative, local refiners had the option to market their surplus production overseas on foreign-flag ships, avoiding the use of higher cost domestic tankers.

While these changes made their greatest impact upon movements of refined products from the Pacific Coast to the eastern U.S., they also contributed to the decline in Gulf/East Coast movements. The following table presents the trend in domestic waterborne movements and exports of residual fuel oil. Since 1980 such shifts resulted in loss of business for about 20 handy-size carriers of this product alone.

Table X
Residual Fuel Oil Movements by Sea
Coastwise Shipments and Exports from U.S. Gulf and West Coast
(000 B/D)

| | Shipments to USEC from U.S. Gulf and U.S. West Coast | | | Exports from U.S. Gulf and U.S. West Coast | | |
|---|---|---|---|---|---|---|
| | USC to USEC | USWC to USEC | Total | USG | USWC | Total |
| 1980 | 210 | 32 | 242 | 16 | 17 | 33 |
| 1981 | 173 | 48 | 221 | 54 | 63 | 117 |
| 1982 | 123 | 18 | 141 | 126 | 81 | 207 |
| 1983 | 73 | * | 73 | 80 | 101 | 181 |
| 1984 est. | 25 | * | 25 | 65 | 105 | 170 |

*Less than 500 barrels/day
Source: Panama Canal Commission, U.S. Department of Energy.

For comparable reasons, shipments of all petroleum products from Puerto Rico to the U.S. mainland declined significantly between 1980 and 1984. Movements from the Virgin Islands to the continental U.S., not covered by the Jones Act, also fell sharply. (Although not required by law, an increasing proportion of the Virgin Islands trade (perhaps over 50%) had been satisfied by U.S. tonnage, after the delivery of several new ITBs for the service.)

Table XI
Shipments of Refined Products to the Continental U.S. From:

| | Puerto Rico | | Virgin Islands | | |
|---|---|---|---|---|---|
| | Gasoline | Total | Residual | Gasoline | Total |
| | 000 B/D | | | 000 B/D | |
| 1980 | 30 | 88 | 174 | 69 | 388 |
| 1983 | 14 | 40 | 118 | 55 | 282 |
| 1984 est. | 12 | 32 | 130 | 50 | 272 |

Source: U.S. Department of Energy

In all of these domestic products trades, the integration of the domestic oil refining industry with the international markets through a policy of deregulation has left the domestic tanker market exposed almost fully to world market forces. This new factor is superimposed upon an already difficult competitive structure in which pipelines and barges have been gaining larger shares of a declining market.

Barring some change in Federal oil policy, including possible tax or increased tariff on imports, the supply of militarily useful tankers without subsidy will decline steadily in the coming years. The world oil market cannot be expected to validate the full cost of maintaining a U.S. products tanker fleet.

The decline of tanker requirements in the domestic refined products trade in recent years has been partly offset by the development of an important market for militarily suitable tankers in the movement of Alaskan and California crude oil to the eastern U.S. At the end of 1984, 36 coated tankers below 100,000 dwt were engaged in moving Alaskan crude, about half from Panama. In addition, five were engaged in the intercoastal shipment of crude oil from California to the U.S. Gulf. The aggregate capacity of coated tankers employed in the crude oil service totalled about 2.5 million dwt, well in excess of the total capacity of coated ships lifting refined products in all coastwise services.

In contrast to the products trade, there are strict limitations on exports of crude oil, and the maintenance through the decade of the fleet useful to the Navy depends entirely on retaining this trade restriction. If the Pacific Basin crudes are retained for domestic use, some further increase in tonnage employed can be expected as output rises further, although continuing efforts to replace small tankers with larger units suggest little change in the number of vessels required.

To a limited extent, the Strategic Petroleum Reserve (SPR) program has provided another market for militarily useful tankers. Long-haul movements are generally served by ships greater than 100,000 dwt, so that smaller tankers usually will be restricted to Mexico or to lightering service. Not more than four vessels between 40,000 and 100,000 dwt, including uncoated ships, will fully satisfy any current requirement.

Similarly, Public Law 480 grain sales, reserved 50% to U.S. flag, do not provide much support for the tanker fleet, given the recent infusion of new efficient dry bulk carrier capacity. At year-end 1984, only one coated tanker of 29,000 dwt was carrying grain abroad.

The largest preference service remaining for U.S. tankers is peacetime military chartering. At the end of 1984, 22 privately owned products carriers were on time or bareboat charters to MSC, aggregating about 700,000 dwt. In addition, a small volume of spot and short period chartering is conducted from time to time. The number of ships and the capacity engaged at the end of 1984 were down from the levels of 1981 and 1982.

Table XII
Privately-Owned tankers on
Time or Bareboat Charter to MSC

| Dec. 31 | # | 000 DWT |
|---|---|---|
| 1984 | 22 | 700 |
| 1983 | 20 | 645 |
| 1982 | 23 | 748 |
| 1981 | 25 | 806 |
| 1980 | 21 | 644 |
| 1979 | 17 | 514 |

Source: Military Sealift Command

All the preference trades have been served in part by the subsidized fleet. At the end of 1984, of 19 subsidized coated tankers below 100,000 dwt, four were time-chartered to MSC, one was laid up, and the remaining 14 were employed in the foreign commercial oil trades or spot MSC business. The Maritime Administration has lately authorized the entry of all into some or all of the preference trades.

B. OUTLINES OF THE SITUATION IN 1989.

Barring further changes in law or regulation that would either promote or damage the economic position of U.S. flag tankers, a continued but slower decline is anticipated in the number and capacity of militarily-useful tankers through the five-year period ending December 31, 1989. Scrappings of tonnage in the small tanker category will persist, although down from the unprecedented rate of 1983-1984. An expansion of sales to the Navy for the Ready Reserve Fleet also is anticipated. This circumstance will result from the further contraction in the range of commercial opportunities in the domestic refined products trades, and increasing competition from imported products and from domestic pipelines and barges. While the movement of crude oil from Alaska and California to the Atlantic may take up part of the slack, the tendency here to utilize larger vessels will minimize benefits to ships below 100,000 dwt.

The following table presents the current employment situation, by trade.

Table XIII
Trading Patterns of Coated and Uncoated
U.S. Flag Tankers under 100,000 DWT
As of 12/31/84

| | Coated | | Uncoated | | Total | |
|---|---|---|---|---|---|---|
| Trade | # of Ships | 000 DWT | # of Ships | 000 DWT | # of Ships | 000 DWT |
| Private | | | | | | |
| USG/EC | 35 | 1,299 | 2 | 85 | 37 | 1,385 |
| WC | 13 | 414 | 1 | 39 | 14 | 454 |
| Intercoastal | 7 | 295 | - | - | 7 | 295 |
| Alaska/WC | 17 | 1,095 | 3 | 179 | 20 | 1,275 |
| Panama/USG | 18 | 1,105 | 2 | 133 | 20 | 1,239 |
| MSC | 24 | 772 | - | - | 24 | 772 |
| SPR | - | - | - | - | - | - |
| PL-480 | 1 | 29 | 1 | 82 | 2 | 111 |
| Caribs | 2 | 79 | - | - | 2 | 79 |
| Foreign Trade | 13 | 816 | - | - | 13 | 816 |
| Total Operations | 130 | 5,905 | 9 | 519 | 139 | 6,424 |
| Repairs* | 2 | 116 | - | - | 2 | 116 |
| Laid-up | 17 | 696 | 5 | 265 | 22 | 961 |
| Private, Current | 149 | 6,716 | 14 | 784 | 163 | 7,500 |
| Newbuildings | 5 | 154 | - | - | 5 | 150 |
| Total | 154 | 6,866 | 14 | 784 | 168 | 7,650 |
| Government | | | | | | |
| Active | 2 | 54 | - | - | 2 | 54 |
| RRF** | 9 | 259 | - | - | 9 | 259 |
| NDRF | 11 | 223 | - | - | 11 | 223 |
| Total Gov't. | 22 | 535 | - | - | 22 | 535 |
| Grand Total | 176 | 7,401 | 14 | 784 | 190 | 8,185 |

*Includes one 80,000 dwt tanker fully employed in ANS/W.C. trade.
**Includes vessels which await funding for future upgrading.
Note: Data may not add to totals due to rounding.

1. The coastwise trade.

With large surpluses of refining, pipeline and barge capacity, movements of clean products by coastwise tankers will tend to decline slowly through the decade. The possible conversion of a Florida Gas natural gas pipeline to a clean products system would substantially curtail what little business remains. Finally, imports of products aboard foreign vessels are likely to continue to diminish domestic ocean shipments of clean products.

It should be emphasized again that the U.S. petroleum market is now largely integrated into the international trading structure. More often than not, the stimulation of both import and export trade by the relaxation of controls has come at the expense of domestic tanker movements. Only occasionally do temporary imbalances and short-term trading opportunities generate spot fixtures of domestic tankers.

Nor are prospects bright for a significant recovery of East Coast refined products demand, once the major market for U.S. tankers, which, by taking up the surpluses of alternative transport, might allow the recovery of other domestic shipping trade. Recent projections of East Coast product demand by Petroleum Industry Research Associates portray an essentially flat East Coast demand pattern.

### Table XIV
### East Coast Refined Products Demand Projection
(Million B/D)

| | 1984(e) | 1985 | 1990 |
|---|---|---|---|
| Motor Gasoline | 2.20 | 2.15 | 2.01 |
| Distillates | 1.05 | 1.03 | 1.01 |
| Residual Fuel Oil | .79 | .76 | .75 |
| All Other | .91 | .93 | .97 |
| Total | 4.94 | 4.86 | 4.74 |

Note: Totals may not add due to rounding.

With East Coast demand stagnant, the process of declining domestic waterborne shipments and increasing imports will necessarily continue. By the end of the decade, domestic waterborne movements of refined products by tankers, including intracoastal and West coast shipments are estimated to decline from about 1.1 million b/d in 1984 to about 600,000 b/d. At a normal ratio between volume and tonnage, a requirement for about 1.1 million dwt is likely by the end of the decade in coastwise tanker trades, including a small volume moved by tanker from the Caribbean.

There are two important corollary comments that can be made with respect to these established trends.

First, the decline in the market for U.S. flag clean products carriers has reached already a level so low that the ready availability of U.S. tankers to MSC for normal peacetime employment is now questionable. The decline of clean-product coastwise movements and consequent reduction of tankers so employed means that few ships are needed for commercial spot liftings. With proprietary and long-term chartered vessels accounting for the preponderance of remaining coastwise cargo lift, MSC now increasingly is forced to secure spot tonnage by chartering idled vessels for periods long enough and rates high enough to justify reactivation. Even this source of capacity is dwindling as older vessels are scrapped or shifted to the Navy's reserve fleet.

A second important development will be the imposition on January 1, 1986 of new tanker clean ballast requirements on existing 20,000-40,000 dwt product carriers of 15 years of age or more. These standards, applicable to all such vessels trading to the U.S., will change the competitive position of U.S. and foreign tonnage.

At first glance, after allowing for the reduced level of clean tanker demand and the delivery of tonnage in recent years that would not be affected by the new rule, the domestic trade at least would not appear to be greatly affected, perhaps to the extent of 150,000 dwt and replacable by otherwise idle tonnage. However, because the marginal ship now seems to be the old 35,000 dwt steam-powered vessel, for which spot or short term rates recently have been barely sufficient to keep the necessary number out of lay-up, the rule will cause what is now the marginal ship to become more uneconomical and will widen the advantage of new ships already meeting the standards, some of which are already more economical. While initially the rule would tend to inflate charter

## Table XV
## The Decline in Clean Trading
## U.S. Flag Tankers Privately Owned, Classified by Trade
## Number of Vessels

| As of June 1 | Proprietary Fleet |  |  |  | Independent Fleet |  |  |  | Overall Total |
|---|---|---|---|---|---|---|---|---|---|
|  | Clean | Dirty | Combined | Total | Clean | Dirty | Combined | Total |  |
| 1984 | 24 | 48 | 3 | 75 | 29 | 79 | 7 | 115 | 190 |
| 1983 | 27 | 49 | 5 | 81 | 49 | 85 | 7 | 141 | 222 |
| 1982 | 31 | 52 | 7 | 90 | 49 | 85 | 9 | 143 | 233 |
| 1981 | 36 | 51 | 4 | 91 | 48 | 92 | 4 | 144 | 235 |
| 1980 | 45 | 51 | - | 96 | 54 | 86 | - | 140 | 236 |
| 1979 | 58 | 51 | - | 109 | 54 | 75 | - | 129 | 238 |
| 1978 | 71 | 42 | - | 113 | 75 | 49 | - | 124 | 237 |
| 1977 | 80 | 34 | - | 114 | 78 | 36 | - | 114 | 228 |
| 1976 | 82 | 36 | - | 118 | 78 | 25 | - | 103 | 221 |
| 1975 | 69 | 47 | - | 116 | 78 | 27 | - | 105 | 221 |
| 1974 | 73 | 47 | - | 120 | 74 | 26 | - | 100 | 220 |

Source: Military Sealift Command.
Note: The census of ships shown here differs slightly from that shown in Table I, due mainly to differences in definition.

## Table XVI

### The Decline in Clean Trading
### U.S. Flag Tankers Privately Owned Classified by Trade
### 000 DWT

| | Proprietary Fleet | | | | Independent Fleet | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Year | Clean | Dirty | Combined | Total | Clean | Dirty | Combined | Total | Overall Total |
| 1984 | 765 | 3,724 | 104 | 4,593 | 984 | 7,609 | 307 | 8,900 | 13,493 |
| 1983 | 839 | 3,563 | 150 | 4,552 | 1,519 | 7,642 | 307 | 9,468 | 14,020 |
| 1982 | 941 | 3,764 | 209 | 4,914 | 1,540 | 7,577 | 327 | 9,444 | 14,358 |
| 1981 | 1,104 | 3,644 | 115 | 4,863 | 1,412 | 7,974 | 119 | 9,505 | 14,368 |
| 1980 | 1,446 | 3,324 | - | 4,770 | 1,618 | 7,606 | - | 9,224 | 13,994 |
| 1979 | 1,789 | 4,449 | - | 6,238 | 1,630 | 5,613 | - | 7,243 | 13,481 |
| 1978 | 2,763 | 2,908 | - | 5,671 | 2,674 | 3,237 | - | 5,911 | 11,582 |
| 1977 | 2,684 | 2,389 | - | 5,073 | 2,605 | 2,665 | - | 5,270 | 10,343 |
| 1976 | 2,621 | 2,270 | - | 4,891 | 2,720 | 1,939 | - | 4,659 | 9,550 |
| 1975 | 2,121 | 2,184 | - | 4,305 | 2,407 | 1,955 | - | 4,362 | 8,667 |
| 1974 | 2,150 | 2,026 | - | 4,176 | 2,302 | 1,578 | - | 3,880 | 8,056 |

Source: Military Sealift Command

rates by reducing capacity and increasing the unit costs of marginal tonnage, commercial petroleum market conditions generally will be working in the opposite direction. With a range of alternative distribution patterns, there rarely will be a necessity to pay much higher domestic freight costs to move refined products. Thus *demand* for tonnage may easily decline as a result of the rule. MSC chartering, generally zlimited to U.S. ships, in contrast, may tend to validate the higher costs drawn by the new requirements.

Among the other services — intercoastal, Caribbean and other foreign trade, government-impelled cargoes (MSC, SPR and P.L.480), and Pacific Basin crude — there does not appear to be much in the way of probable expansion that would offset the declining coastwise demand.

### 2. Intercoastal Trade.

With the virtual disappearance of a once vibrant movement of refined products between the West and East Coasts, future traffic will consist of modest volumes of California crude oil and specialty products and occasional balancing movements of gasoline and fuel oil.

It is anticipated that some of the increase in California crude production will be marketed in the Gulf, stimulating somewhat the demand for tankers in the 50,000-90,000 dwt (Panamax) size range. A full discussion of the West Coast crude oil situation and outlook is presented below.

### 3. Pacific Basin Crude Oil Trade.

At the end of 1984, 18 coated tankers below 100,000 dwt were engaged in the movement of ANS crude from Panama to Gulf and East Coast refineries, 18 such ships made liftings at Valdez or Cook Inlet, and five carried California crude through the Panama Canal, bringing the total employment of militarily useful ships in the Pacific crude trades to 41 vessels, aggregating 2.5 million dwt. These constituted 31% of the number and 42% of the carrying capacity of all militarily useful tankers in operation (including both subsidized and unsubsidized vessels) at that time. These proportions would increase over time as other trades diminish and as West Coast crude oil output rises. Individual vessels, by trade, are identified in Table XVIII (page 31).

#### a. Pacific Basin Oil Production.

Crude oil production in Alaska is now expected to rise slowly through the 1980s, reflecting developments of lesser magnitude than the giant Prudhoe Bay reservoir. These developments will offset the decline of Prudhoe output anticipated in the late 1980s.

Table XVII
Prospective Alaska Oil Production (000 B/D)

| | 1982 | 1985 | 1989 |
|---|---|---|---|
| Prudhoe Bay | 1,536 | 1,540 | 1,300 |
| Kuparuk | 85 | 200 | 250 |
| Cook Inlet | 75 | 50 | 30 |
| Other Northern Alaska | - | - | 270 |
| Total | 1,696 | 1,790 | 1,850 |

## Table XVII
## Employment of Militarily-Useful Tankers in the Movement of Pacific Basin Crude Oil, Year-End 1984

### ANS/W.C.

| Vessel | 000 DWT | Yr. Built (Rebuilt) |
|---|---|---|
| Glacier Bay | 81 | 1970 |
| Sohio Resolute | 81 | 1971 |
| Arco Prudhoe Bay | 70 | 1971 |
| Arco Sag River | 70 | 1972 |
| Chesapeake Trader | 50 | 1982 |
| Chevron California | 70 | 1972 |
| Chevron Mississippi | 70 | 1972 |
| Cove Liberty | 69 | 1954(81) |
| Exxon Houston | 72 | 1964 |
| Exxon New Orleans | 72 | 1965 |
| Exxon Philadelphia | 76 | 1971 |
| Sansinena II* | 70 | 1971 |
| Chevron Colorado | 39 | 1976 |
| Mission Santa Clara | 35 | 1957 |
| Mobil Meridian | 49 | 1961 |
| OMI Yukon | 81 | 1973 |
| Chevron Washington | 39 | 1976 |
| Total (17) | 1,094 | |
| Repairing: | | |
| Sohio Intrepid | 81 | 1971 |

*Cook Inlet crude

### Panama/U.S. Gulf

| Vessel | 000 DWT | Yr. Built (Rebuilt) |
|---|---|---|
| Overseas Chicago | 91 | 1977 |
| Overseas Ohio | 91 | 1977 |
| Baltimore Trader | 58 | 1955(71) |
| Cove Trader | 49 | 1959 |
| Exxon Baton Rouge | 76 | 1970 |
| Exxon San Francisco | 76 | 1969 |
| Overseas Alaska | 62 | 1970 |
| Overseas Arctic | 62 | 1971 |
| Overseas Natalie | 73 | 1961 |
| Exxon Baytown | 57 | 1984 |
| OMI Leader | 38 | 1969 |
| OMI Wabash | 38 | 1969 |
| OMI Willamette | 38 | 1969 |
| Texaco Connecticut | 39 | 1953(71) |
| Texaco Florida | 39 | 1956(71) |
| Washington Trader | 39 | 1959(76) |
| Overseas New York | 90 | 1977 |
| Overseas Washington | 91 | 1978 |
| Total (18) | 1,107 | |

### Calif./U.S. Gulf

| Vessel | 000 DWT | Yr. Built (Rebuilt) |
|---|---|---|
| Exxon Boston | 52 | 1960(80) |
| Exxon Jamestown | 41 | 1957(80) |
| Exxon Lexington | 41 | 1958(80) |
| Exxon Washington | 41 | 1957(80) |
| OMI Hudson | 51 | 1981 |
| Total (5) | 226 | |

The most significant change in the West Coast crude supply picture may develop from recent offshore California discoveries. A proposed pipeline to bring offshore crude to Los Angeles area refineries, along with a connecting line for inland crude producers, would upon completion tend to push additional volumes of ANS crude into Eastern markets.

Table XIX
California Crude Oil Supply (000 B/D)

| | 1982 | 1985 | 1989 |
|---|---|---|---|
| California Onshore/Offshore | 1,023 | 1,000 | 1,025 |
| OCS | 78 | 100 | 300 |
| Total | 1,101 | 1,100 | 1,325 |
| Less: Crude Used for Enhanced Recovery | 128 | 100 | 100 |
| Net Crude Available | 973 | 1,000 | 1,225 |

Including imports estimated at 200,000 b/d in 1985 and thereafter, the total West Coast crude oil supply is expected to rise to 2.99 million b/d in 1985, and 3.28 million b/d in 1989.

b. Pacific Basin Crude Oil Demand.

A second important variable in assessing future tanker requirements is the prospective level of refinery runs along the West Coast. After declining very rapidly from the peak of almost 2.4 million b/d in 1979 to a low of 2.0 million b/d in 1982, refinery runs recovered somewhat in 1983 and rose strongly in 1984. Runs averaged 2.2 million b/d in 1984 and should rise slightly in 1985. Beyond 1985, growth in consumption is likely to be slow, reflecting both cyclical considerations and declining markets for gasoline and residual fuel oil.

The better than expected recovery in West Coast refining activity in 1983-84 is owing in part to an expansion of refined product exports, mainly to the Far East. These exports are stimulated by local crude oil prices that tend to be well below the landed cost of comparable foreign crudes. Net exports of refined products in 1984 were about 60,000 b/d higher than in 1982.

### c. Balance of Pacific Basin Supply and Demand of Oil.

Pacific Basin crude oil supply and demand balances are projected through 1989 as follows:

Table XX
Supply, Demand and Disposition of U.S. Pacific Basin Crude Oil

| | 1982 | 1985<br>(000 B/D) | 1989 |
|---|---|---|---|
| California (net) Production | 973 | 1,000 | 1,225 |
| Alaska Production | 1,696 | 1,790 | 1,850 |
| Crude Imports | 188 | 200 | 200 |
| Total | 2,857 | 2,990 | 3,275 |
| Crude Refinery Runs | 2,020 | 2,240 | 2,325 |
| Crude Oil Surplus | 837* | 750 | 950 |
| Disposition of Surplus | | | |
| ANS to V. Isl. (foreign flag) | 101 | 130 | 130 |
| Calif. to U.S. Gulf | 35 | 35 | 70 |
| ANS to U.S. Gulf | 697 | 585 | 750 |
| | 833* | 750 | 950 |

*Difference reflects stock changes and losses.

### d. Tanker Demand and Supply for Pacific Basin.

(1) Demand for crude carriers. Based upon these forecasts of crude oil output and consumption along the West Coast, a tanker demand projection can be developed. Compared with a peak tanker demand in excess of 7.0 million dwt in 1982, demand is estimated at 6.3 million dwt in 1985, rebounding to 7.2 million dwt in 1989. The principal reasons for the recent contraction of demand were: (a) construction of the trans-Panama pipeline, which curtailed the requirement for vessels distributing crude to the Eastern states; and (b) recovery of West Coast oil demand, entailing both an increase in short-haul movements to Puget Sound and Alaska refineries and a diminution in long-haul intercoastal movements.

Table XXI
Waterborne Movements and Tanker Requirements for Pacific Basin Crude Oil Trade

|  | 1985 |  | 1989 |  |
|---|---|---|---|---|
|  | 000 B/D | 000 DWT | 000 B/D | 000 DWT |
| Intra-Alaska | 60 | 53 | 85 | 75 |
| Valdez/West Coast, Hawaii | 995 | 2,139 | 870 | 1,784 |
| Valdez/Panama | 585 | 2,808 | 750 | 3,600 |
| Total | 1,640 | 5,000 | 1,705 | 5,459 |
| Panama/U.S. Gulf, E.C. | 585 | 1,112 | 750 | 1,425 |
| California/U.S. Gulf | 35 | 175 | 70 | 350 |
| Total |  | 6,287 |  | 7,234 |

*Based upon dwt/b/d ratios of .88 for intra-Alaska, 2.15 for Valdez/W.C., 4.8 for Valdez/Panama, and 1.9 for Panama/U.S. Gulf. The West Coast ratio drops to 2.05 in 1989. The ratio for California/U.S. Gulf shipments is 5.0.

(2) Crude Carrier Supply. The supply of crude carriers, including future deliveries of two Exxon VLCCs and the occasional use of subsidized VLCCs under temporary waivers of trade restrictions, will be sufficient to meet the prospective demand for tonnage. The lists suggest an ample availability of crude carriers in both years. We assume that most of the oldest and smallest tonnage now in the crude trades (chiefly proprietary) would be retired by 1989.

The suggested ship rosters for 1985 and 1989 indicate some stability in prospective demand for militarily useful tankers in the domestic crude oil trades. Table XXII.

Finally, all of the above comments assume the continuation of present policy with respect to the domestic use of ANS crude and the maintenance of the domestic trade rules separating vessels built with and without Federal subsidies.

4. Government Preference Cargoes.

a. P.L. 480.

The P.L. 480 program, once the source of considerable employment for tankers, has now faded in significance. First, the size of the program has decreased, and a total of only two million tons of cargo in fiscal 1984 was available to all U.S. flag ships, including liner cargoes. The program was twice that level in the early 1970s. More profoundly, AID bulk shipments have faded to a few hundred

### Table XXII
### Suggested Rosters of U.S. Crude Carriers in the Pacific Basin Crude Trades

1985

Ships Not Considered Militarily Useful

| Name | 000 DWT | Age in 1985 |
|---|---|---|
| Stuyvesant | 225 | 8 |
| Bay Ridge | 224 | 7 |
| Arco Alaska | 188 | 6 |
| Arco California | 189 | 5 |
| Arco Fairbanks | 120 | 11 |
| Arco Anchorage | 120 | 12 |
| Arco Juneau | 120 | 11 |
| Arco Texas | 90 | 8* |
| B.T. Alaska | 182 | 7 |
| B.T. San Diego | 182 | 7 |
| Adonis | 80 | 11* |
| Atigun Pass | 173 | 8 |
| Brooks Range | 174 | 7 |
| Kenai | 123 | 6 |
| Keystone Canyon | 173 | 7 |
| Thompson Pass | 174 | 7 |
| Tonsina | 123 | 7 |
| Exxon Benicia | 173 | 6 |
| Exxon N. Slope | 173 | 6 |
| Mobil Arctic | 129 | 13 |
| Overseas Boston | 122 | 8* |
| Overseas Juneau | 120 | 12 |
| OMI Columbia | 136 | 7* |
| Prince William Sound | 124 | 9 |
| Manhattan | 114 | 23 |
| Chevron Louisiana | 39 | 8 |
| Petersburg | 50 | 22 |
| Texas Sun | 53 | 25 |
| Pennsylvania Sun | 53 | 26 |
| Subtotal(29) | 3,946 | |
| 2 VLCCs | 490 | 8-11 |
| Subtotal (31) | 4,436 | |

Militarily-Useful

| Name | 000 DWT | Age in 1985 |
|---|---|---|
| America Sun | 81 | 16 |
| Glacier Bay | 81 | 15 |
| OMI Yukon | 81 | 12 |

1989

Ships Not Considered Militarily Useful

| Name | 000 DWT | Age in 1989 |
|---|---|---|
| Stuyvesant | 225 | 12 |
| Bay Ridge | 224 | 11 |
| Exxon N/B | 209 | 3 |
| Exxon N/B | 209 | 2 |
| Arco Alaska | 188 | 10 |
| Arco Anchorage | 120 | 16 |
| Arco California | 189 | 9 |
| Arco Fairbanks | 120 | 15 |
| Arco Juneau | 120 | 15 |
| Arco Texas | 90 | 12* |
| B.T. Alaska | 182 | 11 |
| B.T. San Diego | 182 | 11 |
| Adonis | 80 | 15* |
| Atigun Pass | 173 | 12 |
| Brooks Range | 174 | 11 |
| Kenai | 123 | 10 |
| Keystone Canyon | 173 | 11 |
| Thompson Pass | 174 | 11 |
| Tonsina | 123 | 11 |
| Exxon Benicia | 173 | 10 |
| Exxon N. Slope | 173 | 10 |
| Mobil Arctic | 129 | 17 |
| Overseas Boston | 122 | 12* |
| Overseas Juneau | 120 | 16 |
| OMI Columbia | 136 | 11* |
| Prince William Sound | 124 | 13 |
| Petersburg | 50 | 26 |
| Subtotal (27) | 4,105 | |
| 3 VLCCs | 755 | 12-15 |
| Subtotal (30) | 4,860 | |

Militarily-Useful

| Name | 000 DWT | Age in 1989 |
|---|---|---|
| America Sun | 81 | 20 |
| Glacier Bay | 81 | 19 |
| OMI Yukon | 81 | 16 |

| Name | 000 DWT | Age in 1985 |
|---|---|---|
| Overseas Chicago | 91 | 8 |
| Overseas New York | 90 | 8 |
| Overseas Ohio | 91 | 8 |
| Overseas Washington | 91 | 7 |
| Copper Mountain | 72 | 13* |
| Sohio Intrepid | 81 | 14 |
| Arco Prudhoe Bay | 70 | 14 |
| Arco Sag River | 70 | 13 |
| Chesapeake Trader | 50 | 3 |
| Chevron California | 70 | 13 |
| Chevron Mississippi | 70 | 13 |
| Cove Liberty | 69 | 18* |
| Cove Trader | 49 | 26 |
| Exxon Baltimore | 52 | 25 |
| Exxon Baton Rouge | 76 | 15 |
| Exxon Baytown | 57 | 1 |
| Exxon Boston | 52 | 25 |
| Exxon Houston | 72 | 21 |
| Exxon Jamestown | 41 | 28 |
| Exxon Lexington | 41 | 27 |
| Exxon New Orleans | 72 | 20 |
| Exxon Philadelphia | 76 | 15 |
| Exxon San Francisco | 76 | 16 |
| Exxon Washington | 41 | 28 |
| Mobil Meridian | 49 | 24 |
| Overseas Alaska | 62 | 15 |
| Overseas Arctic | 62 | 14 |
| Overseas Natalie | 73 | 24 |
| Potomac Trader | 50 | 2 |
| Sansinena II | 70 | 14 |
| Texaco Florida | 39 | 22* |
| Chevron Arizona | 39 | 8 |
| Chevron Colorado | 39 | 9 |
| Washington Trader | 39 | 18* |
| Ogden Champion | 38 | 16 |
| Ogden Leader | 38 | 16 |
| Subtotal (39) | 2,461 | |
| Grand Total (70) | 6,697 | |
| Estimated Demand | 6,287 | |

| Name | 000 DWT | Age in 1989 |
|---|---|---|
| Overseas Chicago | 91 | 12 |
| Overseas New York | 90 | 12 |
| Overseas Ohio | 91 | 12 |
| Overseas Washington | 91 | 11 |
| Copper Mountain | 72 | 17* |
| Sohio Intrepid | 81 | 18 |
| Sohio Resolute | 81 | 18 |
| Arco Prudhoe Bay | 70 | 18 |
| Arco Sag River | 70 | 17 |
| Chesapeake Trader | 50 | 7 |
| Chevron California | 70 | 17 |
| Chevron Missippi | 70 | 17 |
| Cove Liberty | 69 | 22* |
| Delaware Trader | 50 | 7 |
| Exxon Baltimore | 52 | 29 |
| Exxon Baton Rouge | 76 | 19 |
| Exxon Baytown | 57 | 5 |
| Exxon Boston | 52 | 29 |
| Exxon Houston | 72 | 25 |
| Exxon Jamestown | 41 | 32 |
| Exxon Lexington | 41 | 31 |
| Exxon New Orleans | 72 | 24 |
| Exxon Princeton | 43 | 7 |
| Exxon Philadelphia | 76 | 19 |
| Exxon San Francisco | 76 | 20 |
| Exxon Washington | 41 | 32 |
| Exxon Yorktown | 43 | 6 |
| Mobil Meridian | 49 | 28 |
| Overseas Alaska | 62 | 19 |
| Overseas Arctic | 62 | 18 |
| Overseas Natalie | 73 | 28 |
| Potomac Trader | 50 | 6 |
| Sansinena II | 70 | 18 |
| Chevron Arizona | 39 | 12 |
| Chevron Colorado | 39 | 13 |
| Ogden Hudson | 51 | 8 |
| Subtotal (39) | 2,526 | |
| Grand Total (69) | 7,386 | |
| Estimated Demand | 7,234 | |

*Average of original stern & reconstructed midbody.

thousand tons. In addition, there has been a tendency toward short-haul shipments to Central America and the Caribbean (from 0.3 million tons in 1978 to 1.3 million tons in 1983), accompanied by the phasing out of some important trades requiring the use of more shipping capacity (Korea, 579,000 tons in 1978, 0 in 1983; Indonesia, 578,000 tons in 1978, 138,000 tons in 1983). There also appears to be a policy to spread a limited program among more recipients (with more emphasis upon low income nations), and a corresponding tendency toward the use of smaller vessels, including liners. Growing use of dry cargo barges can be observed in the nearby Caribbean and Central American trades. But most important, recent years have seen a transformation of the U.S. dry bulk fleet from old uneconomical ships to large, efficient bulkers and combination carriers built abroad, in most instances ruling out employment for U.S. flag tankers in the carriage of dry cargo. For the past three years, with a few exceptions, the only tanker participation was limited to ships en route to scrapyards and able to offer competitive rates on the basis of a one-way voyage covering not much more than fuel costs.

This circumstance is not expected to change and as a result the market offers little relief for owners of small coated tankers.

b. SPR.

Similarly, the SPR program, now down to 159,000 b/d in the current fiscal year, does not allow for much employment of militarily useful tankers. With the decline of Mexican sales to the SPR, greater volumes are being purchased from Great Britain and from Persian Gulf sources, tending to concentrate U.S. liftings in 80,000-265,000 dwt vessels. At this writing, it appears that the SPR program will wind to a close by the end of this fiscal year, as the volume of oil in storage approaches 500 million barrels, stimulated by efforts to reduce Federal expenditures. No allowance for SPR tanker requirements in 1989 is therefore included in our forecast.

### c. MSC.

Direct Navy support represents by far the largest source of preference employment for U.S. flag tankers. At the end of 1984, 22 tankers of 700,000 dwt were engaged on time charters by MSC. A complete list is shown in Table XXIII.

In addition MSC does a moderate amount of spot chartering. With the depletion of the coated tanker fleet by scrapping and long-term lay-up, this method will be less available for any significant portion of its needs. To avoid the necessity of relying upon short period charters to induce reactivation, MSC is expected to minimize its use of tankers by various means, including the use of pipelines in the U.S., and greater purchase of refined products outside the U.S. on a delivered basis.

While the tanker safety rules will reduce available capacity now under charter, their impact on MSC at least until the late 1980s will be minimized by the delivery of the five

Table XXIII
MSC's Time Chartered Tanker Fleet at End-1984

| Vessel | 000 DWT | Yr. Built | Period | Subject to Safety Rules in 1986 |
|---|---|---|---|---|
| Sealift Anarctic | 27 | 1975 | 20 yrs. | No (1990) |
| Sealift Arabian Sea | 27 | 1975 | " | No (1990) |
| Sealift Arctic | 27 | 1975 | " | No (1990) |
| Sealift Atlantic | 27 | 1974 | " | No (1989) |
| Sealift Caribbean | 27 | 1975 | " | No (1990) |
| Sealift China Sea | 27 | 1975 | " | No (1990) |
| Sealift Indian Ocean | 27 | 1975 | " | No (1990) |
| Sealift Mediterranean | 27 | 1974 | " | No (1989) |
| Sealift Pacific | 27 | 1974 | " | No (1989) |
| Texas Trader | 28 | 1944/69 | 5 yrs. | Yes |
| New York Sun | 34 | 1980 | 5 yrs. | No |
| Overseas Valdez | 38 | 1968 | 5 yrs. | Yes |
| Overseas Vivian | 38 | 1969 | 5 yrs. | Yes |
| Overseas Alice | 38 | 1968 | 5 yrs. | Yes |
| Coastal Manatee | 31 | 1961 | 6 mos. | Yes |
| Mormacstar | 39 | 1975 | 2 yrs. | No |
| Falcon Leader | 34 | 1983 | 5 yrs. | No |
| Texaco New York | 39 | 1953/71 | 4 mos. | Yes |
| Cove Navigator | 32 | 1951 | 6 mos. | Yes |
| Falcon Champion | 34 | 1983 | 5 yrs. | No |
| Rover | 35 | 1977 | 4 mos. | No |
| Falcon Countess | 37 | 1972 | 6 mos. | No |
| Total (22) | 700 | | | |

T-5 tankers, combined with the fact that many ships already run light-loaded. No material change, either in number or capacity is anticipated until then. A modest decline in available capacity would then occur which might not be required in any event.

d. Foreign Commercial Trade.

Twelve products carriers and seven 90,000 dwt coated crude carriers were built with subsidy for the foreign commercial trades. Two tankers are being converted to hospital ships, and one has been lost. A number of the remainder already are active in the U.S. preference trades, and as older charters expire, more are likely to compete for this limited business. As new subsidy contracts are precluded, this fleet will remain unchanged.

Several unsubsidized tankers are also employed in foreign trade, particularly in the movement of refined products from Puerto Rico and the Virgin Islands to the U.S. mainland. Such trade will do well to remain at present levels.

5. Summary of Demand.

Based on the foregoing, prospects are for a moderate reduction of total U.S. flag tanker demand in the second half of the decade, with a continuing shift toward the greater use of large crude carriers, reflecting new construction, offset by the further diminution of trades requiring the use of small vessels most suitable for military purposes. Market demand for militarily useful tanker capacity is projected to decline 14%.

Table XXIV
Prospective Peacetime Demand for U.S. Privately Owned Tankers
(000 DWT)

| | 1985 | | 1989 | |
|---|---|---|---|---|
| | Total | Militarily Useful | Total | Militarily Useful |
| Pacific Basin Crude | 6.3 | 2.5 | 7.2 | 2.5 |
| Coastal Intercoastal Prod. | 1.6 | 1.5 | 1.0 | 0.9 |
| MSC-Navy | 0.7 | 0.7 | 0.7 | 0.7 |
| MSC-SPR | 0.5 | 0.1 | - | - |
| P.L. 480 | 0.3* | 0.1 | 0.3* | 0.1 |
| Foreign Trade, Commercial | 0.9 | 0.9 | 0.8 | 0.8 |
| | 10.3 | 5.8 | 10.0 | 5.0 |

*Carriage mainly by combination carriers.

The estimates of demand reflect anticipated requirements in peacetime, and do not suggest potential tanker needs stemming from any military contingency. Furthermore, any possible drawdown of the Strategic Petroleum Reserve as a result of any national emergency has not been factored into these calculations. The shipping implications of an SPR drawdown are being evaluated by a MARAD-industry group.

The change in market opportunities has well defined implications for small and medium-size tankers that will be noted in the final section of this paper, and future contraction means that the major share of tanker capacity required for mobilization must come from other sources.

## 6. Prospective Supply of Militarily-Useful Tankers

Based upon the tanker demand projection, the supply of militarily useful vessels will continue to dwindle for the next few years, although the rate of decline will tend to slow as the surplus of capacity gradually reduces. Including all tankers under charter to MSC (including the Sealift vessels and the T-5 newbuildings), the number of privately owned vessels below 50,000 dwt projected to be active in 1989 totals 71 units. About 40 coated tankers between 50,000 and 100,000 dwt are projected to be employed at that time, and ten ships are assumed to be laid up or idle, bringing the total private fleet useful for military purposes to 121 units of 5.6 million dwt.

We assume that the Ready Reserve Fleet will be brought to 16 vessels, and that virtually all of the old tankers laid up in the NDRF will be scrapped.

The analysis provides for the scrapping and conversion of 27 coated tankers in the private fleet, and the transfer of six to the Reserve Fleet. In addition, five uncoated tankers were deleted, bringing total private fleet deductions to 38 vessels of 1.25 million dwt for the five years ending in 1989. The projected rate of discards, about 250,000 dwt a year, is far below the rates experienced in recent years (770,000 dwt in 1983 and 900,000 dwt in 1984). The slower rate reflects the shrinking number of vessels in the remaining fleet, and a smaller component of over-age product carriers. No provision has been made for scrapping tankers larger than 50,000 dwt, although a number of crude carriers will be at or near the end of their economic lives by 1989.

Table XXV
Recent and Projected Scrappings* of
U.S. Tankers Below 100,000 DWT

| | Coated | | Uncoated | | Total | |
|---|---|---|---|---|---|---|
| Actual: | # | 000 DWT | # | 000 DWT | # | 000 DWT |
| 1981 | 5 | 90 | - | - | 5 | 90 |
| 1982 | 9 | 218 | 2 | 57 | 11 | 275 |
| 1983 | 20 | 564 | 4 | 113 | 24 | 677 |
| 1984 | 0 | 663 | 6 | 194 | 26 | 857 |
| Subtotal | 54 | 1,530 | 12 | 364 | 66 | 1,899 |
| Projected | | | | | | |
| 1985 | 7 | 437 | 2 | 67 | 9 | 504 |
| 1986 | 5 | 150 | 2 | 99 | 7 | 249 |
| 1987 | 8 | 206 | 1 | 49 | 9 | 255 |
| 1988 | 9 | 225 | - | - | 9 | 225 |
| 1989 | 8 | 206 | - | - | 8 | 206 |
| Subtotal | 37 | 1,224 | 5 | 215 | 42 | 1,439 |
| Total 1981-1989 | 91 | 2,759 | 17 | 579 | 108 | 3,338 |

*Includes losses and conversions but excludes transfers to RRF.

The supply of ships and capacity has been adjusted to fit aggregate demand and to reflect segregated or clean ballast requirements on certain products carriers between 20,000 and 40,000 dwt. Choices of individual vessels for specific trades or requirements are based upon historical experience and evaluation of prospective markets, but obviously are matters of arguable judgment. Table XXVI.

Table XXVI presents an estimate of the availability of militarily useful tankers in 1989, compiled by trade.

Table XXVI
Summary of Militarily Useful U.S. Flag Tanker Employment
as of 1989

| Private Fleet: | # | 000 of DWT |
|---|---|---|
| Less than 50,000 DWT: | | |
| MSC | 24 | 723 |
| Pacific Basin Crude | 8 | 336 |
| Other | 39 | 1,261 |
| Subtotal | 71 | 2,320 |
| 50,000-99,999 DWT: | | |
| Pacific Basin Crude | 31 | 2,190 |
| Other | 9 | 713 |
| Subtotal | 40 | 2,903 |
| Total Active | 111 | 5,223 |
| Lay-ups/Idle | 10 | 399 |
| Total Private Militarily Useful Fleet | 121 | 5,622 |
| Government Owned Fleet: | | |
| RRF Acquisitions | 7 | 214 |
| Existing RRF* | 9 | 259 |
| NDRF | 1 | 35 |
| Total | 17 | 508 |

*Assumes upgrading of all vessels acquired will be completed.

| Summary: | | |
|---|---|---|
| Private Fleet | 121 | 5,622 |
| Government Owned Fleet | 17 | 508 |
| Total | 138 | 6,130 |

## III. OTHER TANKER RESOURCES

Considerable discussion has revolved around the availability and utility in emergency of foreign flag shipping. The classes of vessels primarily considered include suitable ships operating (1) under what is called effective control of the U.S. (EUSC) by virtue of American corporate ownership and control, and (2) under the national flags of our NATO partners. Broad economic trends and structural changes in the petroleum industry have also had their impact upon the availability of tonnage within these classifications.

A. EUSC.

Reduction in the control of major oil companies over much of the supply, refining and marketing of OPEC crude oil was important in the restructuring of the petroleum industry during the past ten years. Widespread overcapacity in refining and transportation has impelled closing down or sale of surplus facilities. Moreover, consolidation of the industry through merger has generated further redundancies of capacity. As a result of these factors and the persistent weakness of the petroleum markets, most U.S. owners of refined products carriers under foreign flag have been severely pruning their fleets by scrapping and sale to foreign interests. This process has persisted for the past few years and seems likely to continue for some years although perhaps at a slower pace.

The EUSC fleet of coated tankers under 80,000 dwt as of July 1, 1984 amounted to only 42 ships aggregating 1.5 million dwt. Of these, ten vessels of 400,000 dwt can be identified as nearing the end of their useful lives.

## Table XXVII
## EUSC Fleet of Militarily Useful Tankers
## as of 7/1/84

| Name | DWT | Year Built | Age (Yrs.) | Trade |
|---|---|---|---|---|
| Alden W. Clausen | 35,026 | 1981 | 3 | Pacific Coast |
| Canopus | 30,809 | 1981 | 3 | Caribs |
| Carla A. Hills | 35,035 | 1981 | 3 | Far East |
| Chevron Frankfurt | 78,872 | 1967 | 17 | Worldwide |
| Conastoga | 29,494 | 1972 | 12 | Pacific |
| Corsicana | 29,487 | 1973 | 11 | South Atlantic |
| Esso Bangkok | 22,396 | 1968 | 16 | Northern Europe |
| Esso Bayonne | 29,166 | 1974 | 10 | Worldwide |
| Esso Bombay | 22,396 | 1968 | 16 | Indian Ocean |
| Esso Melbourne | 29,124 | 1974 | 10 | Northern Europe |
| Esso Shimizu | 29,166 | 1973 | 11 | Caribs |
| Esso Zurich | 66,612 | 1965 | 19 | Atlantic |
| Felania | 32,229 | 1975 | 9 | East Atlantic |
| Felipes | 31,720 | 1975 | 9 | Far East |
| Ficus | 31,720 | 1976 | 8 | Indian Ocean |
| Flammulina | 31,720 | 1976 | 8 | Northern Europe |
| Fossarina | 31,692 | 1976 | 8 | Caribs |
| Fossarus | 31,722 | 1976 | 8 | Worldwide |
| Fulgur | 31,720 | 1974 | 10 | South Atlantic |
| Fusus | 31,720 | 1975 | 9 | North Atlantic |
| Jupiter | 31,291 | 197[illegible] | 9 | Caribs |
| Kenneth T. Derr | 35,026 | 1982 | 2 | Caribs |
| Mercury | 31,291 | 1974 | 10 | North Atlantic |
| Mobil Endeavor | 37,873 | 1982 | 2 | Red Sea |
| Mobil Endurance | 37,920 | 1982 | 2 | Pacific |
| Mobil Enterprise | 32,634 | 1983 | 1 | North Atlantic |
| Mobil Marketer | 30,611 | 1974 | 10 | Pacific |
| Mobil Producer | 30,611 | 1974 | 10 | Worldwide |
| Nile | 64,716 | 1981 | 3 | Indian Ocean |
| Ottawa | 39,800 | 1976 | 8 | Northern Europe |
| Saguenay | 39,105 | 1976 | 8 | Med. |
| Volga | 64,652 | 1981 | 3 | Intra-Europe |
| Pacific Hunter | 32,109 | 1979 | 5 | Caribs |
| Pluto | 30,809 | 1981 | 3 | Caribs |
| Sasstown | 30,665 | 1943 | 41 | Caribs |
| Texaco Alaska | 41,382 | 1960 | 24 | Far East |
| Texaco Kentucky | 29,774 | 1949 | 35 | Caribs |
| Texaco Maine | 46,442 | 1959 | 25 | Northern Europe |
| Texaco Ohio | 28,081 | 1949 | 35 | Caribs |
| Texaco Pennsylvania | 28,081 | 1949 | 35 | Caribs |
| Texaco Texas | 29,744 | 1949 | 35 | Central America |
| Timbo | 30,665 | 1943 | 41 | Caribs |
| Total (42) | 1,495,108 | | | |

## B. NATO

By far the greater sealift potential is represented by the tanker fleets of our NATO allies. Availability of these ships in conflicts not involving Western Europe, however, is questionable. In the case of general war, it is assumed, however, that the full tanker fleets with military utility, other than vessels with clear local employment patterns, are made available for war service, although we are not aware of any specific NATO commitment to furnish tankers to us.

NATO members regularly provide rosters of their militarily useful tankers to MarAd. An assessment of the latest available census of NATO tankers between 10,000 and 80,000 dwt shows the following results:

(1) An enormous decline has overtaken the NATO fleets, including the Greek, now losing ships at a rate exceeding one a day. The British tanker fleet has dropped more than half in 10 years. Of the 500+ ships in the class mentioned above, more than 200 have been eliminated by scrapping, sale to shipowners in non-NATO countries, or conversion.

(2) Among the remaining vessels were many medium-size tankers of 60,000-80,000 dwt built in the mid-to-late 1960s. Used chiefly to transport crude oil, there is a question whether this group can properly be considered as militarily useful (they are not likely to be coated).

(3) With a few exceptions, the national fleets are quite old, with an average age exceeding that of the U.S. As presented to MarAd, the average age of the Greek fleet was almost 20 years, Italy about 22 years, the Netherlands 23 years, and the U.K. 13 years.

(4) The national requirement for products carriers to service coastwise needs have also to be noted in a number of instances, particularly Italy. Many ships will not become available to the U.S. under any circumstances.

Considering age, national service requirements, and suitability for American military purposes, the fleet of NATO products tankers that might be available in the next few years is in the order of 150-160 ships, assuming that all the better quality units are earmarked for our use, an unlikely result. The major sources, in order of importance, would be the U.K., Greece, Denmark, and Norway. We make no comment on the likelihood of wholehearted Greek cooperation.

If the size of EUSC and NATO resources, fleets now totalling less than 200 modern units, is not comforting, still less so is that market forces are continuing to drive national flag operations out of the competitive market as operators from the Far East continue to gain market share and the major oil companies consolidate their operations, including transport.

### Table XXVIII
### NATO Rosters of Militarily Useful Tankers, Below 80,000 DWT, as of Mid-1984

| | Original | | Adjusted* | |
|---|---|---|---|---|
| | No. | 000 DWT | No. | 000 DWT |
| Belgium | 5 | 193 | 4 | 128 |
| Canada | 13 | 179 | 2 | 75 |
| Denmark | 29 | 1,242 | 26 | 1,175 |
| France | 10 | 701 | 3 | 110 |
| Germany | 14 | 812 | 12 | 499 |
| Greece | 177 | 7,068 | 91 | 4,282 |
| Italy | 78 | 2,029 | 33 | 881 |
| Netherlands | 11 | 176 | 9 | 175 |
| Norway | 35 | 1,517 | 29 | 1,145 |
| Portugal | 12 | 1,430 | 3 | 80 |
| Turkey | 5 | 235 | 4 | 148 |
| U.K. | 117 | 3,805 | 82 | 2,827 |
| | 506 | 19,387 | 298 | 11,525 |

*Adjusted only for scrappings, other sales, losses, and ships below 10,000 dwt. Many questions remain with respect to inclusion of medium size crude carriers, idle and over-age vessels, and ships in local coastwise trade, and are not reflected in this table.

## C. THE WORLD FLEET.

Even aside from the fleets considered most accessible to the U.S., tanker capacity has been shrinking for many years on a worldwide basis, a result of lower oil consumption, shorter voyage distances, and increased local output not requiring the use of tankers. Declining world capacity is highlighted in the following table which includes all tankers between 10,000 and 100,000 dwt.

Table XXIX
World Supply of Tankers 10,000-100,000 DWT

| DWT Class | 1/1/78 | | 1/1/85(est) | |
|---|---|---|---|---|
| | No. | MM DWT | No. | MM DWT |
| 10,000-40,000 | 1,349 | 33.4 | 1,130 | 28.5 |
| 40,000-80,000 | 599 | 35.4 | 435 | 26.3 |
| 80,000-100,000 | 274 | 24.6 | 305 | 27.0 |
| Total | 2,222 | 93.3 | 1,870 | 81.8 |
| Excluding U.S.-Flag | (230) | (8.8) | (183) | (7.9) |
| Non-U.S. Flag | 1,992 | 84.5 | 1.687 | 73.9 |

It must be recognized that the prices of world tonnage not under flag control will rise sharply in wartime. In 1938, 20-year old Hog Islanders were selling for $5 dwt or less, during a depression in shipping similar to the present; by 1940 they were bringing $100 dwt, and the government in 1942 imposed a ceiling of $75 for its own acquisitions under eminent domain. The heavy shrinkage in the world fleet during the last five years (100 million dwt of tankers scrapped 1980-1984), which is continuing at the rate of 25 million dwt a year, portends a similar price trend should a general war develop in the time period under study. Especially to be remarked is the corresponding shrinkage in European building capacity, which is down by half since 1975, and is not likely to revive under a commercial demand shifted dominantly to the Orient.

## IV. CONCLUSION

When the Tanker Working Group commenced work in 1983, the Secretary of the Navy asked his logistical staff to assist us. We were furnished unclassified "scenarios" suggesting wartime POL requirements. Since then such substantial changes in military thought seemed to have occurred that we do not consider it would be useful to address the demand side of war shipping as originally propounded to us. We have therefore limited our paper to supply only.

We have also decided that it would not be useful to explore means of expanding the fleet if the planning authorities should find a significant shortfall from contingency requirements.

Ideas in this sphere would tend to be found within the historic framework of national maritime policy, which has been to procure defense shipping as an inexpensive by-product of the commercial market operation. This policy is, however, being dismantled. What if any material and human resources for building or operation may be required, and what means might be employed to obtain them must therefore be left for decision by those charged with statutory responsibility for defending the nation.

# STATEMENT OF PETER J. LUCIANO
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SUBMITTED TO THE
COMMITTEE ON FINANCE
U.S. SENATE
October 1, 1985

The Transportation Institute, representing 174 member companies engaged in all aspects of U.S.-flag marine transportation, wishes to take this opportunity to express our views on the Administration's tax reform proposals in light of the impact they may have on the U.S. maritime industry.

The proposals to phase out the Capital Construction Fund (CCF), the investment tax credit, the Accelerated Cost Recovery System as it applies to shipping assets, the tax deduction for business meetings and conventions held aboard U.S.-flag passenger vessels and a host of other harmful tax policies are predicated on ignorance or bias against the U.S. maritime industry.

The rationale for these proposals appears to be based on two key, and certainly erroneous, assumptions. First, that any national security justification for a U.S.-flag merchant marine is no longer relevant and secondly, that shipping operations are now given preferential consideration.

The Institute believes that fair and functional tax treatment of U.S.-flag shipping operations should not be preferential, relative to other American industries. But it should be specialized tax treatment in order to reflect the special, sometimes unique nature of international shipping.

Within the complex international web of government-sponsored maritime promotional policies, against which the U.S. merchant marine must compete, are substantial tax incentives which many foreign governments offer in support of their respective merchant fleets. Those foreign promotional tools are little understood by most government agencies. We would suggest that changes in tax treatment of the U.S. maritime industry should not be undertaken without a thorough understanding of those incentives.

We have attached to our statement a brief summary of some of those foreign tax policies based on the latest information available to us. The summaries represent tax incentives in developing and developed countries alike. They are, however, just brief highlights of a very complex and growing problem. When those incentives are used in tandem with cargo reservation policies and other promotional supports enjoyed by many foreign fleets, the competitive obstacles to the U.S. fleet become virtually impossible to overcome without counterbalancing help from our own government. The Treasury Department's proposal would further disadvantage the U.S. merchant marine by removing the few, modest incentives available for maritime investment.

Moreover, the Department of Treasury's suggestion that a national security requirement for the U.S. merchant marine is unclear, is not only incorrect, but dangerous. One must wonder if those responsible for this proposal consulted officials in the Navy or Department of Defense regarding the validity of that assumption. If they had, we are certain that the indispensable role of the U.S. merchant marine as a sealift asset would have been vigorously stressed.

The Department of the Treasury's tax proposal regarding CCF summarizes that all-too-common misconception this way:

> The special tax treatment of capital construction funds originated, along with a direct appropriations program, to assure an adequate supply of shipping in the event of war. It was thus feared that because of comparative shipbuilding and operating cost disadvantages, peacetime demand for U.S.-flag vessels would not reflect possible wartime needs.
>
> A national security justification for subsidies of U.S. maritime construction is today unclear. U.S. citizens own or control large numbers of ships registered in Panama, Liberia, and Honduras that would be available to the United States in an emergency, and most U.S. allies possess substantial fleets of oceangoing cargo ships that would be available in any common emergency. Largely for this reason, direct appropriations for maritime construction (the construction differential and operating differential subsidies) are being phased out.

First of all, the inadequacy of non-U.S.-flag vessels is already being seen in the creation, by the Department of Defense, of a government-owned commercial-type fleet. The gap between probable national security sealift requirements and available U.S.-flag sealift has grown enormously and attempting to bridge it has become a very expensive proposition for the American people. The Treasury Department's proposal would only increase that burden by decreasing private-sector assets which will then have to be maintained by the taxpayer.

As a result of the worldwide shipping depression, foreign-flag promotional policies, and ill-advised cutbacks in U.S. maritime promotional policies, the U.S.-flag merchant marine has been in precipitous decline. In response to that decline the U.S. Navy created the Ready Reserve Force (RRF), a fleet of merchant vessels purchased, repaired and maintained in layup at government expense. When the RRF was established, a goal was set for the acquisition of 32 ships. In three years the decline of the U.S. merchant marine drove that goal upwards to 100 ships. Now, that goal too, must be adjusted upward. According to Admiral James D. Watkins, Chief of Naval Operations:

> ...We expect to increase to more than 100 ships in the next few years, forced to do so again because of a greater-than-expected decrease in projected U.S. fleet numbers by decade's end.

The program costs to the American taxpayer of maintaining a government-owned U.S. merchant marine are enormous. Sealift programs are one of the fastest growing portions of the Navy budget. Acquisition, maintenance and breakout costs for a ten-year period currently averages more than 17 million for each vessel in the RRF. Multiplied by a 150-ship RRF, the ten-year total approaches $3 billion. The result is essentially a warehouse fleet kept afloat on life support systems in the hope that it will perform within the allotted 5-10 day breakout period. The RRF provides few jobs for the critical sea-going labor pool which would have far fewer employment opportunities if operators have no incentive to invest in shipping assets.

Also, those expensive assets exist solely for operational military sealift. Planning for the RRF does not take into account the shipping needed to supply the U.S. economy with raw materials and other imports, nor guarantee export of U.S. farm commodities or manufactured products. Thus, the growing revenue burden of funding the RRF will only increase if these unsound tax proposals accelerate the decline of the U.S. merchant marine.

Of the U.S.-owned, foreign-flag, foreign-crewed vessels cited by the treasury report as sufficient sealift assets, the Joint Chiefs of Staff (JCS) reports that only 20 dry cargo and 53 tankers are "militarily suitable." The JCS have also concluded two other points in recent annual reports on U.S. Military Posture that: "The United States relies on the nation's merchant marine as a strategic resource." They also concluded that: "Foreign registry is a major detraction from the maintenance of a viable U.S. merchant marine."

As for reliance on allied fleets "which would be available in any common emergency," the United States has not been involved in military conflict in Europe for 40 years and in Korea for 32 years. All other military actions were in the third world where no "common emergency" was perceived by most of our allies (e.g. Viet Nam, Dominican Republic, Grenada, Lebanon, etc.). In addition, NATO assets have been declining as rapidly as our own, in large measure because of the tax advantages enjoyed by FOC, state-controlled and other foreign fleets.

With this general evaluation of the Treasury Department's invalid assumptions, I would like to present the Institute's positions on specific elements of that proposal.

## Capital Construction Fund:

The Institute believes that the Capital Construction Fund is a cost-effective mechanism which serves to bolster the U.S. merchant marine. Treasury's brief and obviously uninformed analysis of the national security benefits inherent in the U.S. merchant marine offered no sound evidence to support its conclusions. Further, no explanation of the questionable methodology used to reach those determinations was presented.

In our view, the Capital Construction Fund (CCF) works. From its inception in 1970 to December 1980, sixty deep sea vessels were built, 139 were reconstructed and 89 vessels were acquired. In terms of tugs, barges and offshore supply boats during that period, 744 were built, 34 were reconstructed and 181 were acquired. Since 1980 at least 30 units in the latter category have been constructed, although complete data has not been compiled by the Maritime Administration since 1980. Like repeal of accelerated depreciation and investment tax credits, elimination of CCF would inhibit fleet modernization, which the Administration and industry alike view as a prerequisite to enhanced U.S. maritime capability.

Critics of American management techniques have often charged that business planners in this country plan only as far as the next quarter while our most successful foreign competitors, notably Japan, plan for the long term. The CCF serves long-term planning needs by allowing for a logical investment strategy which permits an operator to acquire new assets, or modernize existing ones when the business climate is most hospitable.

Funds deposited in a CCF are not exempt from tax but are deferred. Those operators, with current CCF accounts, entered into contractual agreements with the U.S. government which set minimum and maximum deposit levels and required Maritime Administration approval of any funds withdrawn. Disapproved withdrawals are fully subject to tax and interest penalties.

Further, those operators who established CCF deposits did so in good faith as part of their commitment to the long-term existence of the U.S. merchant marine. The CCF is primarily maritime policy, not tax policy.

## Accelerated Cost Recovery and Investment Tax Credits For Maritime Assets:

Under the tax code prior to the implementation of accelerated depreciation schedules, U.S.-flag vessels had a guideline life of 18 years and a minimum asset depreciation range life of 14.5 years. At that time, the United States was 16th among maritime nations for length of depreciable life for vessels and 15th for the total first year depreciation allowed. Whatever the fate of accelerated depreciation and investment tax credits for U.S. industry in general, the Institute vigorously supports continued accelerated depreciation and investment tax credits for U.S.-flag maritime assets. Accelerated depreciation and investment tax credits are sound maritime policy needed to counter even stronger foreign incentives. They are responsive to the cyclical nature of shipping and should be maintained for maritime investments as it is presently written in the code.

In situations such as the current shipping depression, the number of vessels put into layup is quite high. Because of the cyclical nature of ocean shipping, layups are a common occurrence during a vessel's useful life. Thus an extended depreciation period increases the economic burden of layup periods. By contrast, an accelerated depreciation period lessens the economic strain of layup periods and enhances the possibility for investment in shipping assets. The average age of the fleets of nations which allow accelerated depreciation is much lower than nations which do not allow for accelerated depreciation.

Shipping is capital intensive. The time period between signing a contract to build a ship and placing it into operation is normally measured in years. In addition, the demands of developing maritime technology require continual reinvestment. Operators need accelerated depreciation to offset the extended periods when they must commit substantial sums of capital without a return on investment. As the subcommittee is aware, the Administration has repeatedly stressed the need for the U.S. merchant marine to use the most cost-effective, modern equipment available in order to improve its competitive posture. Extending depreciation periods is contrary to the intent of Administration maritime policy since it widens the gap between a fiscally restricted U.S. merchant marine and the tax-favored foreign vessels with which it must compete.

## Passenger Vessel/Convention Tax Deduction:

Unfortunately, the authors of the Treasury Department's tax simplification proposal apparently believe that the current tax deduction for business meetings or conventions held aboard U.S.-flag passenger vessels creates an opportunity for tax abuse that threatens public confidence in the tax code.

What is not generally known, however, is that the Internal Revenue Service convention reporting requirements are much more stringent for passenger vessels than land-based facilities. Convention passengers aboard U.S. vessels are a tiny fraction of those who attend land-based, tax-deductible conventions. For example, the American Planning Association, despite being concerned with events in this country, chose to hold its 1985 tax-deductible convention in Montreal, Canada, at which 3,000 persons were expected to attend in a four-day period. By contrast, one of the two oceangoing U.S. passenger vessels, or both of the paddlewheel steamboats currently operating on U.S. rivers, utilizing every available convention berth, would require five weeks to serve as many convention attendees. A crucial difference in this case would be the fact that the 3,000 U.S. conventioneers in Montreal would contribute to a foreign economy, while those attending aboard a U.S. passenger vessel contribute to America's economic vitality and national security.

By way of example, the historic paddlewheel steamboats, the DELTA QUEEN and the MISSISSIPPI QUEEN, operating on the Mississippi, Ohio, Cumberland and Tennessee Rivers, employ hundreds of crew members and dozens of others in shore-side positions. In addition, the vessels purchase goods and services, and passengers spend travel dollars, in forty cities located in fourteen states, providing much needed and widespread economic activity.

Oceangoing passenger vessel revenues represent a hard currency bonanza for foreign nations, but they are mostly drained from the American economy by foreign-flag vessel operators. In 1983, for instance, the port of Miami saw more than two million passengers spend $1,500 each, virtually every penny on foreign-flag lines, causing a drain on the U.S. balance-of-payments. Market predictions anticipate a ten percent growth rate per year in the number of bookings, and thus the loss of dollars from the U.S. economy is likely to grow.

Many of the passengers sailing on the river paddlewheelers and the only two oceangoing, U.S.-flag passenger vessels currently active, are vacation travelers. But the business generated by the convention trade can mean the difference between profit and loss. Should the passenger vessel tax deduction be eliminated, continued operation of the vessels would, as a result, be jeopardized.

If the passenger vessel/convention deduction is eliminated, the result would be harmful to the U.S. economy in several ways. First, corporate tax revenues from the operating companies would decrease or be lost. Secondly, the 650 sea-going billets, hundreds of crew billets on the river boats and numerous shoreside employees, could lose their jobs and would not likely be replaced in the current shipping depression. If that were to happen, the passengers who would have sailed on U.S.-flag vessels solely for vacation purposes would probably shift to foreign-flag vessels offering vacation cruises and thereby export their dollars. Since many passenger vessel bookings are repeat business, a secure U.S. market share would be lost and the currency drain represented by those passenger revenues would repeat in future years.

Those passengers who are convention travelers would merely shift their bookings to shore-side facilities, many with the attraction of gambling, top-name entertainment, tax deductible rental cars and other amenities not available on passenger ships. Since those alternative land-based convention sites do qualify for the tax deduction, no revenue gain would result by closing the passenger vessel option. In fact, as we stated previously, land-based reporting requirements are much less stringent so the potential for abuse is greater. If a land-based convention site chosen as an alternative to a U.S. passenger vessel is located in Canada, Mexico or a number of eligible Caribbean nations, then the negative impact on the U.S. balance-of-payments would be even greater since the convention travel dollars spent would employ foreign, rather than American workers.

Contributions to the U.S. economy, however, are not the only way these ships enhance American strength. The U.S.-flag ocean-going passenger vessel fleet currently consists of only two ships, the INDEPENDENCE and the CONSTITUTION, providing a seven-day service among the Hawaiian Islands. The ships employ 650 merchant seamen, about five percent of the rapidly dwindling shipboard labor pool which is essential to national security. As you know, American national interests and regional instability often coincide in such areas as the Middle East, where land-based facilities for U.S. troops are either unsafe or unavailable. In such situations, the use of passenger vessels as offshore troop or hospital ships, protected by U.S. naval power, is of immeasurable value.

If ill-advised tax proposals undermine the operations of U.S.-flag passenger ships, U.S. military planners may no longer have two, 22.5 knot 30,090 DWT 3,000-4,000 troop/hospital ships to carry men and materiel across the vast reaches of the Pacific. The most recent example of passenger vessels used in support of a modern military operation is, of course, the Falkland Islands campaign. During that engagement three British passenger vessels, the UGANDA, CANBERRA and QUEEN ELIZABETH 2 were rapidly called into service. Although the foreign seamen serving on those ships refused to sail into danger in Great Britain's behalf, once British ratings were aboard, operations went smoothly. (No such problem exists with the two oceangoing U.S.-flag passenger ships which carry U.S. crews.)

The UGANDA, about half the size of the two U.S.-flag vessels, was quickly converted to a one thousand-bed hospital ship carrying a 135 member hospital team plus crew. Acting as a hospital, the UGANDA averaged 40 to 70 casualties a day, once seeing 159 in four hours for a total of 730, while performing 554 battle operations and serving 212,000 meals to combat troops during a four-month period.

The CANBERRA was fitted with a hospital but was used as a troopship. As a hospital, she received 172 battle casualties, all of whom survived, performed 84 operations and 5,189 lab tests, made 172 x-rays and collected 1,310 pints of badly needed blood. This was performed by 208 medical personnel and stretcher bearers as opposed to a peace-time medical staff of five. The CANBERRA also carried 3,000 troops and the civilian crew helped to keep them from harm despite repeated aerial attacks and constant danger. The QE2 served as a troop ship carrying 3,150 troops through an 100-iceberg hazard in dense fog, to safely disembark troops and supplies and to evacuate 700 British sailors whose three ships had been sunk in the South Atlantic.

As you know, the U.S. Navy asked, and received, standby permission from the British government for use of a U.K.-flag passenger ship during the successful Grenada operation. Naval officials have also held discussions with the owners of the two oceangoing, U.S.-flag passenger vessels for use in a military crisis. The Administration's commitment to a strong national defense is inconsistent with the proposal to eliminate the passenger vessel tax deduction.

Unfortunately, the country perhaps most aware of the commercial/military value of passenger ships is the Soviet Union. According to Soviet statistics, in 1983 the U.S.S.R.'s militarily useful passenger vessel fleet of 87 vessels, the world's largest, carried 3.5 million passengers. Included among them were 600,000 foreign passengers who paid hard currency to sail to such places as the coast of Alaska and helped to make the Soviet merchant marine the U.S.S.R.'s fourth largest source of hard currency. Although Soviet passenger vessels earning money to finance aggressive militarism is certainly alarming, even more disquieting is the advantage the Soviets have over the U.S. in the potential for use as military assets, represented by those vessels. With the current increased awareness of U.S. national security interests, it is quite disconcerting that such a serious military imbalance favoring the Soviets is so rarely mentioned.

In closing, Mr. Chairman and members of the Committee, I can only repeat the Institute's vigorous opposition to elimination, phase out or cut back of the Capital Construction Fund, the passenger vessel convention deduction and accelerated depreciation and investment tax credits for maritime assets. We also stand ready to assist the Committee or any government body in the formulation of tax policy for the U.S. merchant marine.

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## TAX STATEMENT ATTACHMENT

### JAPAN:

Establishment of a tax-free reserve is permitted for funds used for ship repair, replacement and marine pollution control costs. Tanker operators may set aside one percent of revenues in a tax-free fund. Regular depreciation is permitted in addition to a special 15 percent depreciation for the first year. Tax credits against foreign trade earnings are available.

### WEST GERMANY

German-flag operators may have 80 percent of revenues received from international trade taxed at half the normal rate. Profits from the sale of vessels owned at least six years may be placed in a tax-free fund. In May 1984 the West German government took steps to reduce operators/owners exposure to non-revenue oriented taxation. West German vessels have received tax-free fuel.

DENMARK:

Owners may depreciate as much as 30 percent of the cost of a ship in advance at a rate of 15 percent per year. After the initial 30 percent depreciated in advance, an operator can deduct 30 percent of a vague "index-related balance" each following year.

SWEDEN:

Operators receive a direct grant based on income taxes paid by crews. Depreciation of 30 percent per year or full value over five years is permitted.

GREECE:

Operators accrue indirect benefits from substantial tax concessions made to Greek seafarers who pay us little as 4.8 percent tax on total take home pay and bonuses. Published profits are used as an operator's tax criterion but substantial corporate funds are reportedly kept in tax havens thus avoiding most Greek taxes. A tax exemption during lay up, or a six year tax exemption, or a 50 percent tax exemption, are options available to operators of Greek-built and registered vessels.

NORWAY:

Numerous depreciation schedules to fit an owner's needs. Profits from ship sales may be put in tax-free reserve. Seamen's tax concessions include a fixed monthly expense deduction and large tax-free allowances especially for those on foreign trade vessels.

THE NETHERLANDS:

A tax credit of 12.5 percent of amount invested is allowed. A daily tax allowance for crews also benefits operators by lowering shipboard labor costs.

ITALY:

Tax-free vessel replacement funds are permitted and all ships are exempt from value added tax.

MEXICO:

Cotton exporters receive a 97.7 percent reduction in export tax if Mexican-flag vessels are used. Honey exporters pay 1/3 of export tax if Mexican-flag vessels are used. The Mexican Export Tax mechanism provides progressive rebates for other exporters using Mexican-flag vessels. The Mexican Decree on

Fiscal Incentives provides a 10 percent tax credit for the transport costs of imports carried on Mexican-flag vessels.

PHILIPPINES:

Exporters may deduct 150 percent of transport costs if Philippine-flag vessels are used. If companies are registered with the Board of Investments, they will be permitted to deduct 200 percent of transport costs for exports or imports if Philippine-flag vessels are used.

TANZANIA:

Foreign-flag i.e. non-Tanzanian, vessels are taxed on gross receipts carrying outbound Tanzanian cargo and passengers.

URUGUAY:

Shippers using Uruguaian-flag vessels to carry export cargoes receive substantial tax allowances.

BRAZIL:

Exporters using Brazilian-flag vessels may earn tax credits for the purchase of raw materials for use in the manufacture of company products.

PEOPLES REPUBLIC OF CHINA:

Taxes are levied on exports and passengers carried on foreign-flag vessels, calculated on gross outbound voyage income, unless a bilateral agreement forbids it.

THAILAND:

Shippers may receive a 50 percent deduction of transport costs for imports and exports if Thai-flag vessels are used.

GUATEMALA:

A 100 percent tax is levied on imports from certain countries unless carried on national-flag vessels.

INDONESIA:

A tax of 4 percent of gross revenues is levied on foreign-flag vessels transporting passengers and cargo from Indonesia.

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Sources:

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Seatrade, June 1985.